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Auto Dealership Engagement Manual, Volume 2

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INTEGRATED PRACTICE SYSTEM

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AUTO DEALERSHIP ENGAGEMENT MANUAL

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SUBSTANTIVE TESTING

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CHAPTER 7

SUBSTANTIVE TESTING

7.000 PURPOSE

7.001 Substantive tests are procedures applied to account balances or classes of transactions to determine if there are material misstatements in the financial statements. These tests provide the bulk of the evidence obtained on auto dealership audits.

7.002 The nature, timing, and extent of the tests are generally based on the assessments of inherent and control risk made during the planning phase of the engagement. For example, the higher the assessment of control risk, the more rigorous the substantive tests should be. If analytical procedures done during the planning phase of the engagement suggest that some account balances are unexpectedly high or low, the auditor may determine that those balances warrant more testing. Tests' effectiveness can be modified by changing their nature (for example, tests of details or analytical procedures), timing (testing as of the balance-sheet date or an interim date), or extent (testing 100% or sampling). Similarly, the auditor may be able to change the same factors to make audits more efficient. While the main objective is to perform an effective audit, if alternative tests are equally effective the auditor should choose the most efficient one.

7.003 Planning occurs throughout the engagement and as a result the auditor might have to reassess risk as the engagement unfolds. For example, even if tests of controls indicated that an area had low risk and the auditor planned substantive tests accordingly, information might come to the auditor's attention during the audit that requires reassessment of the risk. Such information might include, for example, unexpected deviations from control procedures, errors that the internal controls should have caught, or new information about transactions or balances.

7.100 TYPES OF SUBSTANTIVE TESTS

7.101 There are two broad categories of substantive tests: tests of details and analytical procedures.

- Tests of details are procedures applied to the <u>individual items</u> that compose an account balance or class of transactions. The tests involve confirmation, inspection, or observation procedures to provide evidence about the recorded amount.
- Analytical procedures are tests applied to the <u>total</u> recorded amounts and are based on the existence of plausible and consistent relationships among financial statement elements or between financial and nonfinancial amounts.

7.102 The auditor may obtain evidence from any combination of tests of details and analytical procedures. As a general rule, tests of details provide stronger evidence and, therefore, are more effective. But analytical procedures can also be effective:

- For certain types of assertions (for example, the completeness assertion, which cannot be tested directly using a test of details on recorded amounts).
- When the relationships between amounts are very predictable.
- When the data used to develop expectations based on the relationship are reliable.
- When relatively precise expectations can be developed.

7.103 The Auto Dealership Tests of Balances Audit Program presumes that tests of details will constitute the bulk of the substantive tests on most auto dealership audits. However the auditor should be alert to opportunities to use analytical procedures whenever they can be economically, but effectively, employed.

7.200 UNIQUE ASPECTS OF AUTO DEALERSHIP AUDITS

7.201 Some of the areas on auto dealership audits that require special tests or considerations include:

- Used-car inventory. Valuations of used cars are generally tested by reference to published valuation guidelines.
- Notes payable under floor plan arrangements. Floor plan notes are generally confirmed with lenders. Special attention should be paid to issues dealing with collateralization and valuation of the underlying inventory and the timely payment of the notes.
- F&I income. Collectibility of F&I income is generally subject to future chargebacks. The adequacy of the reserves for these future chargebacks is tested through analysis of historical data and application of analytical procedures.
- Contracts in transit. The contracts are generally tested by inspecting subsequent receipts.
- Environmental and workplace safety issues. Because dealerships generally must store and dispose of gas, oil, and batteries, environmental issues can be significant. Tests in this area generally consist of inquiries and observations, as well as reviewing the dealership's policies for handling and disposing of hazardous waste. Also, dealerships are subject to various federal and state regulations on safety in the workplace. Most dealerships' repair and body shops are subject to these regulations.
- Regulatory Environment. The industry is highly regulated. Such regulations extend to many aspects of the dealership operations in addition to the environmental area, such as deceptive advertising, fair credit and disclosure requirements, motor vehicle operations, emission control and safety inspection, zoning, and a host of specific state and local laws.
- Industry profitability. The industry is cyclical and it might be necessary to apply analytical procedures to industry data or data from other dealerships instead of relying on year-to-year comparisons. Going-concern issues might also exist.

7.300 TESTS OF DETAILS

7.301 Testing on auto dealerships consists largely of tests of details. The following paragraphs discuss how the timing and extent of the tests is determined.

Timing

7.302 Tests of details are generally done on balances as of the balance-sheet date, although in some cases balances may be tested as of an interim date. In that case the auditor should:

- Consider whether there are rapidly changing business conditions that might predispose management to misstate the financial statements in the period after the date tested,
- Compare information concerning the balance at the balance-sheet date with comparable information at the interim date tested to identify unusual amounts,
- Apply additional tests of details or analytical procedures to provide a reasonable basis for extending the conclusions about the balance at the interim date to the balance at the balance-sheet date, and
- Consider coordinating the tests of interrelated accounts and cutoffs (such as testing floor plan liabilities and inventory as of the same date).

7.303 Generally balances are tested as of an interim date only when control risk for the related assertions are assessed at below the maximum. That is, when controls have been tested and found to be effective for that assertion.

Sampling

7.304 The requirements for both statistical and nonstatistical sampling are established by SAS No. 39, *Audit Sampling* (AU 350), and explained in the AICPA Audit and Accounting Guide, *Audit Sampling* (AAG-SAM). These pronouncements discuss the factors that are considered in deciding whether to sample, determining sample sizes, and evaluating sample results. Sampling guidance for tests of details is provided in Chapter 5, section 5.300.

7.400 ANALYTICAL PROCEDURES AND USING THE WORK OF A SPECIALIST

Analytical Procedures

7.401 Analytical procedures can provide evidence supporting financial statement assertions and, thus, can be used as substantive tests. Analytical procedures are often the least expensive tests. Accordingly, they should be used whenever practical.

7.402 SAS No. 56, *Analytical Procedures* (AU 329), describes analytical procedures as follows:

> Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:
>
> a. Financial information for comparable prior period(s) giving consideration to known changes.
>
> b. Anticipated results — for example, budgets or forecasts including extrapolations from interim or annual data.
>
> c. Relationships among elements of financial information within the period.
>
> d. Information regarding the industry in which the client operates — for example, gross margin information.
>
> e. Relationships of the financial information with relevant nonfinancial information.

7.403 Whenever analytical procedures are applied as substantive tests, the auditor must apply the following procedures:

1. Consider whether the relationship is plausible and predictable.
2. Consider whether the data used for the comparison is reliable
3. Consider whether the account balance tested is consistent with the auditor's expectations. If it is not consistent, obtain the client's explanation for the variance and get evidence to corroborate the client's explanation.

7.404 The Auto Dealership Test of Balances Audit Program contains recommended analytical procedures. But be alert for additional opportunities to apply these procedures whenever they are effective and practical.

7.405 Preliminary analytical procedures done in planning are discussed in Chapter 4, sections 4.354 to 4.357.

7.406 At the conclusion of the audit the auditor should compare the financial statements to previous years and to industry data as an overall review. The worksheet in section 10.910 may be completed as part of that effort.

Using the Work of a Specialist

7.407 In July 1994, the AICPA issued SAS No. 73, *Using the Work of a Specialist*, to provide guidance to an auditor who uses a specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions. SAS No. 73, which supersedes SAS No. 11 and its two interpretations, is not expected to dramatically change current practice for auditors who use the work of a specialist. However, the Statement (1) clarifies the applicability of the guidance, (2) provides updated examples of situations that might require using the work of specialists and types of specialists being used today, and (3) provides guidance on using the work of a specialist who is related to the client.

7.408 Auditors may use specialists' work as evidential matter in performing substantive tests to evaluate material financial statement assertions such as actuaries (to determine employee benefit obligations), appraisers, engineers, and environmental consultants. When using the work of a specialist, the auditor should —

- Evaluate the professional qualifications of the specialist
- Obtain an understanding of the nature and scope of the work and the assumptions used by the specialist and test, as considered appropriate, the data provided to the specialist, taking into consideration the auditor's assessment of control risk.
- Evaluate the relationship of the specialist to the client to ensure that the specialist's objectivity was not impaired. If objectivity may have been impaired, the auditor should perform additional procedures to determine that the findings are not unreasonable.
- Consider whether the specialist's findings support the related assertions in the financial statements. If there is a difference between the findings and the assertions, the auditor should apply additional procedures, which may include obtaining the opinion of another specialist. If the difference still cannot be resolved, the auditor should qualify the opinion or disclaim an opinion because of a scope limitation. If the auditor concludes that the assertions are not in conformity with GAAP, the auditor should issue a qualified or adverse opinion.

7.409 Generally, the auditor's report should not refer to the work of the specialist. However, if the report is modified or an explanatory paragraph is added as a result of the report or findings, the specialist may be referred to and identified.

7.410 The Tests of Balances Program in this Manual includes audit procedures the auditor should perform when using the work of an actuary or another specialist.

7.411 SAS No. 73 is effective for audits of financial statements for periods ending on or after December 15, 1994. Early application is encouraged.

7.500 AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

7.501 This program has been designed to provide substantive evidence (when combined with appropriate planning and, when appropriate, evidence from tests of controls) that is sufficient to support the assertions in the client's financial statements. The program should be modified for each audit to reflect overall engagement risk, risks of potential misstatements, the results of analytical procedures done in planning, and the selection of the most cost-beneficial audit approaches and procedures.

7.502 The program addresses the financial statement assertions discussed in SAS No. 31 (AU 326), *Evidential Matter*:

- Existence or occurrence — whether the assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period.
- Completeness — whether all transactions and accounts that should be presented in the financial statements are so included.
- Rights and obligations — whether assets are the rights of the entity and liabilities are obligations of the entity at a given date.
- Valuation or allocation — whether asset, liability, revenue, and expense components of the financial statements have been included in the financial statements at appropriate amounts.
- Presentation and disclosure — whether particular components of the financial statements are properly classified, described, and disclosed.

7.503 The audit program identifies audit objectives used to structure the accumulation of evidence regarding the assertions. Then the program lists specific audit tests intended to achieve those objectives. There is not necessarily a one-to-one relationship between audit objectives and procedures. Some auditing procedures relate to more than one objective. On the other hand, a combination of audit procedures may be needed to achieve a single objective.

7.504 The in-charge should modify the standard program based on the assessment of overall engagement risk from the Client Acceptance and Continuance Form, the Risk of Potential Misstatements Evaluation Form, the Auto Dealership Internal Controls Questionnaire, the Planning Matrix, the All-Substantive Approach Questionnaire, the Auto Dealership Tests of Controls Programs and on the results of performing preliminary analytical procedures. The engagement executive should review the program after interim work. Any inapplicable or unnecessary procedures should be marked "N/A" before the year-end fieldwork is begun.

7.505

Auto Dealership Tests of Balances Audit Program

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This program has been developed for use on auto dealership audit engagements. It is not a substitute for professional judgment. The minimum tests of balances procedures and sample sizes will be selected for System A or B with satisfactory results from controls testing and analytical procedures. Certain additional procedures and/or increased sample sizes in tests of balances may be required for financial statement assertions with control risk assessed at the maximum, i.e., System C. The same will be required for the tests of balances in audits using the All-Substantive Approach.

The Auto Dealership Planning Matrix, the Auto Dealership Internal Controls Questionnaire, the Auto Dealership Risk of Potential Misstatements Evaluation Form, and the results of the tests of controls and analytical procedures should be used for guidance when modifying this program and selecting sample sizes under the ABC System. The All-Substantive Approach Questionnaire and analytical procedures should guide modification.

After the tests of controls and analytical procedures are completed, this Auto Dealership Tests of Balances Audit Program should be modified by the in-charge and reviewed by the engagement partner. The "W/P Ref." column should be marked "N/A" for any steps not applicable.

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

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AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

I. CASH

Objectives:

1. Existence/ownership — To determine that cash exists and is owned by the dealership (existence and rights assertions)

2. Proper cutoff — To determine that cash balances reflect a proper cutoff of cash receipts and disbursements (existence and completeness assertions)

3. Completeness — To determine that cash balances as presented in the balance sheet properly reflect all cash items (completeness assertion)

4. Collectibility — To determine that contracts in transit are collectible (valuation assertion)

5. Proper classification — To determine that cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed (presentation assertions)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Request confirmation of bank balances as of the balance-sheet date from depositories with which the dealership did business during the year. (Direct loans can be confirmed at the same time. Use the Standard Form to Confirm Account Balance Information with Financial Institutions.) (1)	______	______	______
C. Request bank cutoff statements for a period of ________ days after the balance-sheet date. (2, 3)	______	______	______
D. Consider requesting separate confirmation of:			
1. Authorized signatories. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
I. CASH (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
2. Compensating balance restrictions. (4, 5)	______	______	______
3. Other items, such as contingent liabilities, called for by other areas of this program. (5)	______	______	______
E. Obtain reconciliations of bank accounts as of the balance-sheet date.	______	______	______
1. Trace book balance to general ledger. (1)	______	______	______
2. Agree bank balance to confirmation. (1)	______	______	______
3. Trace deposits in transit to the cutoff statement and determine that time lag is reasonable. (1, 2)	______	______	______
4. Ascertain that all checks returned with cutoff statement that were dated before the balance-sheet date are shown as outstanding on the reconciliation. (1, 2)	______	______	______
5. Determine that checks shown as outstanding on the reconciliation cleared during the cutoff period. Consider the reasonableness of significant amounts that have not cleared. (2)	______	______	______
6. Investigate any unusual reconciling items. (1, 2, 3)	______	______	______
F. Ascertain locations, custodians, and amounts of cash on hand.	______	______	______
1. Count significant cash funds on hand. (1)	______	______	______
2. Obtain confirmation of fund's amount and composition from custodian for any cash on hand fund that is not counted. (1)	______	______	______
G. Prepare or obtain a bank transfer schedule showing transfers between bank accounts (including affiliated companies) for ______ days before and after the balance-sheet date. (1, 2)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
I. CASH (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
1. Determine that all transfers were recorded in the financial records in the same period for both bank accounts. (1, 2, 3)	______	______	______
H. Investigate large deposits and disbursements for ______ days before and after the balance-sheet date to see if they were properly recorded. (2)	______	______	______
I. Consider reclassifying any bank overdrafts. (5)	______	______	______
J. Inquire as to the existence of restrictions on availability of recorded amounts, such as compensating balance agreements. (5)	______	______	______
1. Review loan documents for evidence of restrictions. (5)	______	______	______
2. Agree any compensating balance agreements to confirmations from financial institutions. (5)	______	______	______
3. Determine that such restrictions are adequately disclosed in the financial statements. (5)	______	______	______
K. Obtain or prepare a schedule of contracts in transit as of the balance-sheet date. (1, 3)	______	______	______
1. Trace total to the general ledger. (1)	______	______	______
2. Examine the age of the contracts. If any contract is more than one week old investigate its collectibility through inquiry and, if necessary, confirmation. (4)	______	______	______
L. Obtain a list of contracts in transit showing the date of subsequent receipt.			
1. Reconcile the schedule with the general ledger balance. (1)	______	______	______
2. Trace subsequent receipts to deposit records. Normally all contracts in transit should clear within 20 days. Determine the reasons for any unusual time lags. (4)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
I. CASH (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
3. For any contracts that did not clear, examine underlying documentation and determine their ultimate collectibility. (4)	______	______	_____
M. Additional procedures:			
________________________________			
________________________________			
________________________________			
________________________________	______	______	_____

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

II. INVESTMENT SECURITIES

Financial Statement Assertions

Existence or occurrence (E)
Completeness (C)
Rights and obligations (R)
Valuation or allocation (V)
Presentation and disclosure (P)

Objectives:

- Existence—To determine that the entity owns the securities at the balance-sheet date and has physical evidence of ownership (securities, receipts from responsible custodians, etc.) (assertions E, C, and R)
- Proper valuation—To determine that the market or other fair value of the securities has been determined as objectively as practicable (assertion V)
- Income recognition—To determine that related income, gains, and losses from the investment securities is properly recorded and received (assertions C, R, and V)
- Identification of restrictions—To determine that restrictions, pledges, or liens on any of the investment securities and related liabilities are identified and adequately disclosed in the financial statements (assertions E, C, R, and P)
- GAAP conformity—To determine that the financial statement presentation and disclosure of investment securities, including off-balance sheet items such as options and other derivative instruments, and related income, gains, and losses are in conformity with GAAP consistently applied (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the following to determine the nature, timing, and extent of procdures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
II. INVESTMENT SECURITIES (Continued)

Procedures	Done by	Date	W/P Ref.
B. Obtain a list of securities at balance-sheet date, including descriptions, number of shares, cost, carrying amount, and market value. Foot and tie to the general ledger. Review subsequent transactions to determine the completeness of the list. (E and C)	______	______	______
C. Examine securities on hand at the balance-sheet date and obtain a receipt for their return. (E and R)	______	______	______
D. Obtain confirmation of securities held by others at the balance-sheet date. (E, C, and R)	______	______	______

> **Practice Tip**
>
> All confirmation requests should be mailed by the auditor.

Procedures	Done by	Date	W/P Ref.
E. 1. Determine that all debt and equity securities are properly classified as held-to-maturity, available-for-sale, or trading by reference to the nature of the security and management's ability and intention to hold. (P)	______	______	______
2. For debt securities classified as held-to-maturity:			
a. Determine that they are valued at amortized cost. (V)	______	______	______
b. Recalculate amortized cost. (E,C,V, and P)	______	______	______
3. For debt and equity securities classified as available-for-sale:			
a. Determine that they are valued at fair value and, on a test basis, agree to third party market value quotations. (E,C,V, and P)	______	______	______
b. Recalculate unrealized gains and losses and determine that they are included as a separate component of stockholders' equity. (V and P)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
II. INVESTMENT SECURITIES (Continued)

Procedures	Done by	Date	W/P Ref.
4. For debt and equity securities classified as trading securities:			
a. Determine that they are valued at fair value and, on a test basis, agree to third party market value quotations. (E,C,V, and P)	______	______	______
b. Recalculate unrealized gains and losses and determine that they are included in earnings. (Vand P)	______	______	______
5. Obtain a schedule of all sales of investment securities, by category, and transfers between categories during the year and determine whether they have been accounted for properly. (Sales of held-to-maturity securities may "taint" the entire category.) (C, V, and P)	______	______	______
F. Examine brokers' advices and/or directors' approval for major transactions during the period. (E and V)	______	______	______
G. Obtain a list of all derivative transactions. (E and C)			
1. Examine evidence of the transactions and appropriate approval of the transactions. (E, C, and R)	______	______	______
2. Obtain confirmations of outstanding transactions as of year end. (E)	______	______	______
3. Review subsequent transactions to determine completeness of the list. (C)	______	______	______
4. For disclosure purposes obtain and evaluate information concerning significant individual or group concentrations of credit risk. (P)	______	______	______
5. Determine that any gains or losses have been properly recorded. (V and P)	______	______	______
H. Determine if any securities are pledged or restricted. (P)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
II. INVESTMENT SECURITIES (Continued)

Procedures	Done by	Date	W/P Ref.
I. Ensure that all information needed for financial statement disclosures has been accumulated and documented in the workpapers. (Refer to the Auto Dealership Financial Statement Disclosure and Auditor's Report Checklists in Chapter 11) (P)	______	______	______
J. Additional procedures: ______ ______ ______ ______	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

III. ACCOUNTS RECEIVABLE

Objectives:

1. Existence — To determine that all receivables are bona fide receivables (existence and rights assertions)
2. Completeness — To determine that all receivables are included in the financial statements (completeness assertion)
3. Collectibility — To determine that all receivables are collectible or that appropriate allowances have been made for those that aren't (valuation assertion)
4. Classification — To determine that all receivables are properly classified and related party transactions are properly disclosed (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.

Practice Tip:

SAS No. 67, *The Confirmation Process,* allows the auditor to dispense with confirming accounts receivable when any of the following conditions exist:

- Accounts receivable are immaterial to the financial statements.
- The use of confirmations would be ineffective (that is, based on the auditor's experience he or she concludes that response rates to properly designed confirmation requests will be inadequate or responses are expected to be unreliable).
- The auditor has tested the control structure policies and procedures over the relevant assertions and found them to be sufficiently effective to assess control risk as low *and* the auditor applies analytical procedure or other substantive tests sufficient to achieve an appropriately low level of audit risk.

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
III. ACCOUNTS RECEIVABLE (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Factory Receivables			
1. Obtain copies of all available factory receivable statements, such as holdbacks and closeouts, and reconcile to the general ledger balances. (1, 2)	______	______	______
2. For incentives receivable:			
a. Inquire of client as to procedures used to record incentives and chargebacks. (1, 2)	______	______	______
b. Review balance for reasonableness. (1, 2)	______	______	______
c. Examine evidence of subsequent collection. (3)	______	______	______
3. Review statements for any significant fluctuations. (1, 2, 3)	______	______	______
a. If there are significant fluctuations, inquire as to the reasons. (1, 2, 3)	______	______	______
b. Consider the reasonableness of any explanations and obtain information to corroborate them. (1, 2, 3)	______	______	______
C. Due from Finance Companies			
1. Request confirmation of balances from financial institutions. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
III. ACCOUNTS RECEIVABLE (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
2. Obtain copies of reconciliations between statement balances and the balances recorded in the dealership's financial records. (1, 2)	______	______	_____
a. Test the clerical accuracy of the reconciliation. (1, 2)	______	______	_____
b. Trace the book balance to the general ledger. (1, 2)	______	______	_____
c. Agree the balance per the financial institution to the confirmation. (1, 2)	______	______	_____
d. Investigate any unusual reconciling items. (1, 2)	______	______	_____
e. Trace commissions recorded on books but not in the financial institution's statement to subsequent statements and consider the reasonableness of the time lag. (1)	______	______	_____
f. Trace payments shown by the financial institution but not by the dealership to subsequent cash receipts and consider the reasonableness of the time lag. (1)	______	______	_____
3. Compare the balance with the prior year. (1, 2)	______	______	_____
a. If there are significant fluctuations, inquire as to the reasons. (1, 2)	______	______	_____
b. Consider the reasonableness of any explanations and obtain information to corroborate them. (1, 2)	______	______	_____
4. Determine the adequacy of the reserve for finance and insurance income by analyzing chargebacks against F&I income. (3)	______	______	_____
D. Customer accounts			
1. Obtain an aged accounts receivable trial balance. (1, 2)	______	______	_____
a. Trace the balance to the general ledger. (1, 2)	______	______	_____

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
III. ACCOUNTS RECEIVABLE (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
b. Test the clerical accuracy. (1, 2)	______	______	______
c. Test the accuracy of the aging by selecting _______ invoices and comparing the balances and the dates to that shown on the aged trial balance. (The accuracy of the statements are tested through the confirmations in Step C.2.) (3)	______	______	______
2. Confirm __________ accounts using positive confirmation based on the appropriate sample size selection worksheet. (1)	______	______	______
a. Investigate all exceptions noted on confirmations received. (1)	______	______	______
b. Send second requests for confirmations not returned. (1)	______	______	______
c. Apply alternative procedures, including examination of subsequent cash receipts, for confirmations not received after two requests. (1)	______	______	______
3. If the balances were confirmed as of an interim date, prepare a rollforward to the balance-sheet date. (1, 2)	______	______	______
a. Analyze transactions from the confirmation date to the balance-sheet date. (1, 2)	______	______	______
b. Trace amounts shown to the general ledger and monthly source journals. (1, 2)	______	______	______
c. Investigate any unusual amounts or transactions. (1, 2)	______	______	______
4. Prepare or obtain a comparative aging of receivables for three years. Consider the effect on collectibility of any deterioration of the age of receivables. (3)	______	______	______
5. Scan aged trial balance to consider whether receivables from related parties exist for possible disclosure or reclassification. (4)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
III. ACCOUNTS RECEIVABLE (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
6. Determine whether customer deposits are recorded as credits to this account. If the amount is significant consider the need to reclassify them as liabilities. (4)	______	______	______
E. Other receivables			
1. Prepare or obtain a schedule of other accounts receivable. (1, 2)	______	______	______
a. Compare balances from current and prior years. (1, 2)	______	______	______
b. Investigate large balances and significant variances by, for example, confirming material amounts with debtors or examining canceled checks, notes, and other supporting documentation. (1, 2)	______	______	______
2. Determine that the terms and amounts of any loans with related parties are adequately disclosed and properly classified. (See also Section XVIII. on related parties). (4)	______	______	______
3. Determine that any noncurrent portions of receivables are appropriately classified. (4)	______	______	______
4. Consider reclassification of material credit balances. (4)	______	______	______
5. Consider whether any loan terms call for unreasonable interest rates that would require imputation of interest. (3, 4)	______	______	______
F. Allowance for doubtful accounts.			
1. Prepare or obtain an analysis of the allowance. (1)	______	______	______
2. Consider the results of other procedures, such as the review of the accounts receivable aging and any confirmation responses, on the allowance. (3)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
III. ACCOUNTS RECEIVABLE (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
3. Compute the following ratios and compare them to those from prior years and, if available, relevant industry data to determine the appropriateness of the allowance. When unexpected fluctuations occur inquire as to the reasons, consider the reasonableness of the response, and obtain corroboration for it. (3)	______	______	______
a. Allowance for doubtful accounts/gross amounts receivable. (3)	______	______	______
b. Percent of receivables in each aging category. (3)	______	______	______
c. Average days' sales in accounts receivable (that is, receivables/(sales/365)). (3)	______	______	______
d. Sales returns and allowances/gross sales. (3)	______	______	______
e. Sales discounts/gross sales. (3)	______	______	______
f. Gross profit/gross sales. (3)	______	______	______
g. Sales/receivables. (3)	______	______	______
4. Consider updating receivables for subsequent receipts. (3)	______	______	______
G. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

IV. NEW VEHICLE INVENTORY

Objectives:

1. Existence and ownership — To determine that quantities properly represent products, materials, and supplies on hand, in transit, in storage, or on consignment that belong to the dealership (existence, rights assertions)

2. Pricing — To determine whether items are priced in conformity with GAAP not in excess of market (valuation assertion)

3. Accuracy — To determine that inventory listings are accurately compiled, extended, footed, and summarized and totals are properly reflected in the accounts (existence, completeness, valuation, and presentation assertions)

4. Slow-moving and obsolete inventory — To determine that excess, slow-moving, obsolete, and defective items are reduced to net realizable value (valuation assertion)

5. Disclosure — To determine that any liens are appropriately disclosed in the financial statements (disclosure assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Physical inventory			
1. Discuss the inventory plans with the client. Obtain the count instructions and review them for reasonableness. (1)	______	______	______
2. If the client has more than one location, determine, based on quantities, values, and other factors, which locations' inventory counts should be observed. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
IV. NEW VEHICLE INVENTORY (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
3. Observe the counting of portions of the physical inventory to determine that the client's count instructions have been followed. (1)	______	______	______
4. Make _______ test counts of inventory quantities, noting whether the client has properly identified and described the items. The number of test counts should be determined on the appropriate sample size selection form. (1)	______	______	______
5. Control the count sheets. Either take copies of all count sheets used or note the numbers of those used, ensure that only one item has been recorded on each sheet and record (unobserved by the client) additional counts for later tie-in to the inventory summarization. (1)	______	______	______
6. Make a final walk-through to determine that all vehicles were counted. (1)	______	______	______
7. Obtain copies of the last _____ receiving reports and the last ____ sales for later cutoff work. (1)	______	______	______
C. Summarization			
1. Obtain summarized physical inventory. (3)	______	______	______
2. Test the summary's arithmetic accuracy and agree the total to the trial balance. (3)	______	______	______
3. Physical quantities.	______	______	______
a. Determine that the number of count sheets summarized agrees to the number previously determined to have been used in the control, above. (3)	______	______	______
b. Agree test counts to summary to test the accuracy and completeness of the summarization of quantities. (3)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
IV. NEW VEHICLE INVENTORY (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
c. If copies of count sheets were received at the time of the physical count, agree ____ quantities from the summarization to the count sheets to test existence of summarized quantities. If copies were not taken, determine that items were not added to the summary. The form of this test will depend on the client's inventory count and summarization procedures. (3)	______	______	______
d. Test cutoff.	______	______	______
(i) Insure that the last receipts were included in liabilities and inventory and the first receipts after the inventory date were not. (1)	______	______	______
(ii) Insure that the last sales were included in the year's sales (and vehicles were not included in inventory) and the first sales were not. (1)	______	______	______
4. Pricing.			
a. Select ______ items for price testing. The number tested should be based on the appropriate sample size selection form. (2)	______	______	______
b. Agree price used to original invoices. (2)	______	______	______
5. Valuation.			
a. Consider appropriateness of inventory quantities in relation to current period sales. (4)	______	______	______
b. Consider current trends such as the turnover rate (cost of sales/inventory) and gross profit percentage. (4)	______	______	______
6. If the client uses LIFO, compute the LIFO reserve in accordance with the method elected by the client. Review IRS form 970, "Election of LIFO Method" and any forms 3115 related to LIFO changes. (3)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
IV. NEW VEHICLE INVENTORY (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
7. Determine that inventory pledged or collateralized for wholesale finance liability (floor plan) is adequately disclosed in the financial statements. (5)	______	______	______
D. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

V. USED VEHICLE INVENTORY

Objectives:

1. Existence and ownership — To determine that quantities properly represent products on hand, in transit, in storage, or on consignment that belong to the dealership (existence, rights assertions)

2. Pricing — To determine whether items are priced in conformity with GAAP not in excess of market (valuation assertion)

3. Accuracy — To determine that inventory listings are accurately compiled, extended, footed, and summarized and totals are properly reflected in the accounts (existence, completeness, valuation, and presentation assertions)

4. Slow-moving and obsolete inventory — To determine that excess, slow-moving, obsolete, and defective items are reduced to net realizable value (valuation assertion)

5. Disclosure — To determine that any liens are appropriately disclosed in the financial statements (disclosure assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Physical inventory			
1. Discuss the inventory plans with the client. Obtain the count instructions and review them for reasonableness. (1)	______	______	______
2. If the client has more than one location, determine, based on quantities, values, and other factors, which locations' inventory counts should be observed. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
V. USED VEHICLE INVENTORY (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
3. Observe the counting of portions of the physical inventory to determine that the client's count instructions have been followed. (1)	______	______	_____
4. Make _______ test counts of inventory quantities, noting whether the client has properly identified and described the items. The number of test counts should be determined on the appropriate sample size selection form. (1)	______	______	_____
5. Control the count sheets. Either take copies of all count sheets used or note the numbers of those used, ensure that only one item has been recorded on each sheet and record (unobserved by the client) additional counts for later tie-in to the inventory summarization. (1)	______	______	_____
6. Make a final walk-through to determine that all vehicles were counted and consigned goods identified. (1)	______	______	_____
7. Inquire if any inventory is stored in public warehouses, on consignment, or is otherwise off premises. (1)	______	______	_____
a. Request confirmations directly from public warehouses, suppliers, processors, auctions, consignees, or other holders of the company's inventory. (1)	______	______	_____
8. Obtain copies of the last _____ receiving reports and the last ____ sales for later cutoff work. (1)	______	______	_____
C. Summarization			
1. Obtain summarized physical inventory. (3)	______	______	_____
2. Test the summary's arithmetic accuracy and agree the total to the trial balance. (3)	______	______	_____
3. Physical quantities.	______	______	_____
a. Determine that the number of count sheets summarized agrees to the number previously determined to have been used in the control, above. (3)	______	______	_____

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
V. USED VEHICLE INVENTORY (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
b. Agree test counts to summary to test the accuracy and completeness of the summarization of quantities. (3)	_____	_____	_____
c. If copies of count sheets were received at the time of the physical agree ____ quantities from the summarization to the count sheets to test existence of summarized quantities. If copies were not taken, determine that items were not added to the summary. The form of this test will depend on the client's inventory count and summarization procedures. (3)	_____	_____	_____
d. Test cutoff.	_____	_____	_____
(i) Insure that the last receipts were included in liabilities and inventory and the first receipts after the inventory date were not. (1)	_____	_____	_____
(ii) Insure that the last sales were included in the year's sales (and vehicles were not included in inventory) and the first sales were not. (1)	_____	_____	_____
4. Pricing.			
a. Select ______ items for price testing. The number tested should be based on the appropriate sample size selection form. (2)	_____	_____	_____
b. If inventory is based on actual cost:			
(i) Agree prices used to individual invoices. (2)	_____	_____	_____
(ii) Test reconditioning costs included in inventory valuation by agreeing costs to source documents or records tested in internal control testing. (2)	_____	_____	_____
(iii) Determine that the wholesale price exceeds cost. (2)	_____	_____	_____

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
V. USED VEHICLE INVENTORY (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
c. If inventory is based on market:			
(i) Agree market price to wholesale price based on a published source such as the balance-sheet date edition of the Kelly Blue Book. (2)	______	______	______
(ii) Determine that market does not exceed actual cost, including reconditioning costs. (2)	______	______	______
5. Valuation.			
a. Consider appropriateness of inventory quantities in relation to current period sales. (4)	______	______	______
b. Consider current trends such as the turnover rate (cost of sales/inventory) and gross profit percentage. (4)	______	______	______
6. If the client uses LIFO, compute the LIFO reserve in accordance with the method elected by the client. Review IRS form 970, "Election of LIFO Method", and any forms 3115 related to LIFO changes. (3)	______	______	______
7. Determine that inventory pledged is adequately disclosed in the financial statements. (5)	______	______	______
D. Additional procedures:			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

VI. PARTS INVENTORY

Objectives:

1. Existence and ownership — To determine that quantities properly represent products, materials, and supplies on hand, in transit, in storage, or on consignment that belong to the dealership (existence and rights assertions)

2. Pricing — To determine whether items are priced in conformity with GAAP not in excess of market (valuation assertion)

3. Accuracy — To determine that inventory listings are accurately compiled, extended, footed, and summarized and totals are properly reflected in the accounts (existence, completeness, valuation, and presentation assertions)

4. Slow-moving and obsolete inventory — To determine that excess, slow-moving, obsolete, and defective items are reduced to net realizable value (valuation assertion)

5. Disclosure — To determine that any liens are appropriately disclosed in the financial statements (disclosure assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Physical inventory			
1. Discuss the inventory plans with the client. Obtain the count instructions and review them for reasonableness. (1)	______	______	______
2. If the client has more than one location, determine, based on quantities, values, and other factors, which locations' inventory counts should be observed. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
VI. PARTS INVENTORY (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
3. Observe the counting of portions of the physical inventory to determine that the client's count instructions have been followed. (1)	______	______	______
4. Make ______ test counts of inventory quantities, noting whether the client has properly identified and described the items. The number of test counts should be determined on the appropriate sample size selection form. (1)	______	______	______
5. Control the count sheets. Either take copies of all count sheets used or note the numbers of those used, ensure that only one item has been recorded on each sheet and record (unobserved by the client) additional counts for later tie-in to the inventory summarization. (1)	______	______	______
6. Make a final walk-through to determine that all vehicles were counted and obsolete or consigned goods identified. (Be on the lookout for items that appear old. For example, some parts may be dusty from non-use or still have old inventory tags attached. Sometimes general conversations with client personnel counting the inventory can help in identifying old parts.) (1, 4)	______	______	______
7. Inquire if any inventory is stored in public warehouses, on consignment, or is otherwise off premises. (1)	______	______	______
a. Request confirmations directly from public warehouses, suppliers, processors, auctions, consignees, or other holders of the company's inventory. (1)	______	______	______
8. Obtain copies of the last _____ receiving reports and the last ____ sales for later cutoff work. (1)	______	______	______
C. Summarization			
1. Obtain summarized physical inventory. (3)	______	______	______
2. Test the summary's arithmetic accuracy and trace total to the trial balance. (3)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
VI. PARTS INVENTORY (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
3. Physical quantities.			
a. Determine that the number of count sheets summarized agrees to the number previously determined to have been used in the control, above. (3).	______	______	______
b. Agree test counts to summary to test the accuracy and completeness of the summarization of quantities. (3)	______	______	______
c. If copies of count sheets were received at the time of the physical agree ____ quantities from the summarization to the count sheets to test existence of summarized quantities. If copies were not taken, determine that items were not added to the summary. The form of this test will depend on the client's inventory count and summarization procedures. (3)	______	______	______
d. Test cutoff.			
(i) Insure that the last receipts were included in liabilities and the first receipts after the inventory date were not. (1)	______	______	______
(ii) Insure that the last sales were included in the year's sales (and vehicles were not included in inventory) and the first sales were not. (1)	______	______	______
e. Inquire about any major differences between physical and book inventory amounts. Consider the reasonableness of the client's explanation and apply other procedures as appropriate. (3)	______	______	______
4. Pricing.			
a. Select ______ items for price testing. The number tested should be based on the appropriate sample size selection form. (2)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
VI. PARTS INVENTORY (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
b. Agree price used to current invoices or other cost assumptions, such as current manufacturer's price books. (If other cost assumptions are used, determine that they are reasonable in the circumstances. For example, if current manufacturer's prices are used, determine that those prices are not materially different than actual costs.) (2)	______	______	______
5. Valuation.			
a. Consider appropriateness of inventory quantities in relation to current period sales and usage. (4)	______	______	______
b. Consider current trends such as the turnover rate (cost of sales/inventory) and gross profit percentage. (4)	______	______	______
6. If the client uses LIFO, compute the LIFO reserve in accordance with the method elected by the client. Review IRS form 970, "Election of LIFO Method." (3)	______	______	______
7. Determine that any inventory pledged is adequately disclosed in the financial statements. (5)	______	______	______
D. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

VII. PREPAID EXPENSES

Objectives:

1. Proper recording — To determine that the balances represent costs that are properly allocable to future periods (existence, completeness, rights, and valuation assertions)

2. Support for additions — To determine that additions are properly supported (existence and valuation assertions)

3. Appropriateness of amortization — To determine that the method used to amortize amounts is rational, systematic, and consistent (valuation and presentation assertions)

4. Recognition of impairment — To determine that any impairment of the balance is recognized by write-downs charged to operations (valuation and presentation assertions)

5. Proper classification — To determine that the balances and related expenses are properly described and classified in the financial statements (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Obtain schedules of prepaid expenses.			
1. Agree balances to trial balance. (1)	______	______	______
2. Test the arithmetic accuracy of the schedules. (1)	______	______	______
C. Agree amounts charged to supporting documents such as vendors' invoices, contracts, agreements, and insurance policies. (2)	______	______	______
D. Review the amortization methods and periods for reasonableness. (3, 5)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
VII. PREPAID EXPENSES (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
E. Compare account balances and expenses with prior year amounts and investigate reasons for significant fluctuations. (1, 4)	______	______	______
F. When practical, agree activity in prepaid accounts with corresponding expense and accrual accounts. (3, 5)	______	______	______
G. Additional procedures: ______________________ ______________________ ______________________ ______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

VIII. WARRANTY CLAIMS

Objectives:

1. Existence/completeness — To determine that all warranty claims existing as of the balance-sheet date are recorded (existence and completeness assertions)

2. Aging — To determine that the claims are aged correctly (valuation assertion)

3. Collectibility — To determine that claims are collectible, or allowance is made for those that are not (rights, valuation, and presentation assertions)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Obtain a schedule of warranty claims receivable, including warranty claims advance. (1)	______	______	______
1. Test the arithmetic accuracy of the schedule. (1)	______	______	______
2. Trace the balance to the trial balance. (1)	______	______	______
C. Determine if aging is reasonable. Compare the aging to previous year and determine the reasons for any significant differences. (2)	______	______	______
D. Inquire as to the collectibility of the claims. (3)	______	______	______
E. Trace ________ warranty receivables to the repair order for the vehicle under warranty. (1)	______	______	______
F. Review subsequent credits received from the factory. (3)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
VIII. WARRANTY CLAIMS (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
G. Additional procedures:			
______________________			
______________________			
______________________			
______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

IX. PROPERTY AND EQUIPMENT

Objectives:

1. Existence — To determine that fixed assets exist and are owned by the client (existence and rights assertions)

2. Additions — To determine that fixed asset additions are authentic, recorded at cost, and properly distinguished from maintenance and repairs expense (existence, completeness, valuation, and presentation assertions)

3. Retirements — To determine that retirements, proceeds from salvage, and related costs to remove fixed assets are properly recognized (existence and valuation assertions)

4. Leases — To determine that capitalizable leases are properly treated and disclosed as fixed assets and that operating leases are appropriately enclosed (existence, completeness, valuation, rights, and presentation assertions)

5. Depreciation — To determine that a proper amount of depreciation expense is allocated to the period based on the assets' cost, estimate useful life and salvage, calculated and presented in conformity with GAAP (valuation and presentation assertions)

6. Recoverable value — To determine that the net carrying value is expected to be recovered through the ordinary course of business (valuation and presentation assertions)

7. Encumbrances — To determine that any encumbrances and liens are identified and adequately disclosed in the financial statements (presentation assertion; completeness assertion for liabilities)

8. Classification — To determine that idle fixed assets and fully depreciated fixed assets are properly classified and described in the financial statements (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
IX. PROPERTY AND EQUIPMENT (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
B. Obtain a summary of property and equipment and related depreciation showing prior year balances, current year additions and deletions (expense and retirements/disposals for depreciation) and current year ending balances. (1, 2, 3, 5)	______	______	______
1. Test the arithmetic accuracy of the schedule. (1)	______	______	______
2. Trace the balances to the trial balance. (1)	______	______	______
C. Additions			
1. Agree additions to property and equipment to supporting documents, such as invoices or contracts. (2)	______	______	______
2. Consider physical inspections of property and equipment additions. (2)	______	______	______
3. Review the client's capitalization policy for reasonableness and examine supporting documents for items charged to repairs and maintenance. (2)	______	______	______
4. Compare repairs and maintenance expense to the prior year's amount and investigate any significant fluctuations. (Coordinate with work performed in Section XIII., Step 6.) (2)	______	______	______
D. Depreciation			
1. Reconcile additions to accumulated depreciation to related expense accounts. (5)	______	______	______
2. Test calculation of depreciation expense. (5)	______	______	______
3. Review the reasonableness of estimated useful lives used. (5)	______	______	______
4. Determine that depreciation methods are in accordance with GAAP. Compare the methods of computing depreciation and estimated useful lives employed to those used in prior years for consistency. (5)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
IX. PROPERTY AND EQUIPMENT (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
5. Obtain or prepare an analysis of differences between tax and book depreciation. (These procedures are intended to accomplish objectives related to Section XIII.J., Income Taxes)	_____	_____	_____
a. Document the methods employed for tax purposes and consider whether they have been consistently applied.	_____	_____	_____
b. Review current year changes for tax purposes and test the computations.	_____	_____	_____
c. Determine whether additions and retirements were properly treated for tax purposes.	_____	_____	_____
E. Asset Disposals			
1. Compare asset disposals with deletions from accumulated depreciation. Determine that correct cost and depreciation were removed by comparing the amounts to fixed asset records. (3)	_____	_____	_____
2. Agree sales prices to supporting documents, such as sales contracts, when significant. (3)	_____	_____	_____
3. Recalculate gains and losses and agree the total to the trial balance or general ledger posting. (3)	_____	_____	_____
4. Scan revenue accounts for significant proceeds from sales of assets. (3)	_____	_____	_____
F. Leased Assets			
1. Obtain a schedule of leased assets, such as service department lifts, diagnostic equipment, computer systems, and telephone systems, and consider whether leased assets qualify as capital or operating leases. (4) Consider:	_____	_____	_____
a. Lease term (4)	_____	_____	_____
b. Estimated economic life of the property (4)	_____	_____	_____

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
IX. PROPERTY AND EQUIPMENT (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
c. Fair value at inception and end of the lease (4)	______	______	______
d. Minimum lease payments (4)	______	______	______
e. Executory cost provisions (4)	______	______	______
f. Renewal option terms (4)	______	______	______
g. Interest rate implicit in the lease (4)	______	______	______
h. Client's incremental borrowing rate (4)	______	______	______
i. Present value of the lease payments (4)	______	______	______
j. Purchase options (4)	______	______	______
2. For capital leases:			
a. Agree the lease terms to contracts. (4)	______	______	______
b. Test the calculations of the capitalizable amount and the amortization of the leasehold. (4)	______	______	______
c. Agree these amounts to the trial balance. (4)	______	______	______
3. For operating leases:			
a. Agree the lease terms to contracts. (4)	______	______	______
b. Agree the rental expense to the trial balance. (4)	______	______	______
c. Obtain and test a schedule of future minimum rental payments for each of the succeeding five years. (4)	______	______	______
G. Vehicle Leases			
1. Obtain a schedule of vehicles under long-term leases showing the name of lessee, period of the lease, description of the transaction, and financing. (4)	______	______	______
2. Confirm the terms of ______ leases directly with lessees. (4)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
IX. PROPERTY AND EQUIPMENT (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
3. Review the client's determination of which leases are sales-type and which are direct-financing leases. (4) Consider:	______	______	______
a. Lease term (Open end leases should generally be treated as direct financing leases). (4)	______	______	______
b. Fair value of the leased property. (4)	______	______	______
c. Minimum lease payments. (4)	______	______	______
d. Residual value. (4)	______	______	______
e. Interest rate. (4)	______	______	______
4. Test the mathematical accuracy of the calculations necessary for sales-type leases. (4)	______	______	______
5. Reconcile the rental income for other leases to the trial balance. (4)	______	______	______
6. Determine that the lease terms are disclosed in conformity with GAAP. (4)	______	______	______
H. Other			
1. Consider whether the cost of any significant fully depreciated assets being carried in the accounts needs to be disclosed in the financial statements. (8)	______	______	______
2. Determine that any impairment of value of assets has been adequately recognized. (6)	______	______	______
3. Determine that assets pledged, secured, or otherwise encumbered are adequately disclosed. (7)	______	______	______
4. Obtain information about any major capital asset programs and related commitments and determine that they are adequately disclosed. (This procedure is directed towards disclosure of commitments and contingencies — see Section XX.)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
IX. PROPERTY AND EQUIPMENT (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
I. If the entity has adopted SFAS No. 121 and any events or changes in circumstances have occurred indicating that the carrying amount of a long-lived asset may not be recoverable:			
1. Determine if an impairment loss should be recognized. [An impairment loss should be recognized if the carrying amount of an asset exceeds estimated future cash flows (undiscounted and without interest charges).]	______	______	______
a. Review the estimate of future cash flows for mathematical accuracy and, through discussion with management and review of any supporting documentation, determine that assumptions used are reasonable.	______	______	______
2. If an impairment loss should be recognized, test the calculation of the loss. [Impairment loss is measured as the amount by which the asset's carrying amount exceeds its fair value.]	______	______	______
a. Test the fair value used in the calculation by vouching to quoted market prices or by reviewing the valuation technique used.	______	______	______
b. If the fair value is based on the present value of estimated future cash flows, test for mathematical accuracy and ensure that the assumptions used in the present value calculation, including the discount rate, are reasonable.	______	______	______
J. Additional procedures: ________________________________			
________________________________			
________________________________			
________________________________	______	______	______

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

X. INVESTMENTS AND OTHER ASSETS

Objectives:

1. Existence — To determine that the entity owns the investments and other assets at the balance-sheet date and has physical evidence of ownership (securities, policies, receipts from responsible custodians, etc.) (existence, completeness, and rights assertions)

2. Proper valuation — To determine that the values of the investments and other assets have been determined as objectively as practicable (valuation assertion)

3. Income recognition — To determine that related income from the investments and other assets are properly recorded and received (existence, completeness, and valuation assertions)

4. Identification of encumbrances — To determine that liabilities, restrictions, pledges, or liens related to any of the investments and other assets are identified and adequately disclosed in the financial statements (rights and presentation assertions; completeness assertion for liabilities)

5. GAAP conformity — To determine that the financial statement presentation and disclosure of investments and other assets, and related income and expenses (such as classification, cost, equity, etc.) are in conformity with generally accepted accounting principles consistently applied (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
Review the results of the applicable sections of the following to determine the nature, timing and extent of procedures.			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
A. Obtain schedules of investments and other assets and agree to general ledger.	______	______	______
B. Confirm:			
1. Securities held by others. (1)	______	______	______
2. Cash surrender value of life insurance. (2)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
X. INVESTMENTS AND OTHER ASSETS (Continued)

Procedures (Objective(s))	Done by	Date	W/P Ref.
C. For life insurance, reconcile prepaid premiums at beginning of period, premiums paid, and increase in cash surrender value with life insurance expense. (3)	______	______	______
D. Review ____ calculations of investments earnings and related accruals for reasonableness. (3)	______	______	______
E. Examine documentation supporting investment transactions during the year. (1, 2)	______	______	______
F. For equity method investments, determine current value at balance-sheet date and at report date. (2)	______	______	______
G. If investments are carried on the equity method:			
1. Determine the company's equity in net assets at year-end and earnings (losses) and distributions for the year based on audited information. (2, 3)	______	______	______
2. Obtain a reconciliation of intercompany transactions and balances. Determine reasonableness. (5)	______	______	______
3. Check computation of amortization of cost over book value. (2, 3)	______	______	______
H. Determine if any investments are pledged or restricted. (4)	______	______	______
I. For majority-owned subsidiaries, determine that consolidated presentation complies with GAAP. (5)	______	______	______
J. Additional procedures:			
________________________________			
________________________________			
________________________________			
________________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XI. DEFERRED CHARGES AND INTANGIBLES

Objectives:

1. Proper recording — To determine that the balances represent costs that are properly allocable to future periods (existence, completeness, rights, and valuation assertions)

2. Support for additions — To determine that additions are properly supported (existence and valuation assertions)

3. Appropriateness of amortization — To determine that the method used to amortize amounts is rational, systematic, and consistent (valuation and presentation assertions)

4. Recognition of impairment — To determine that any impairment of the balance is recognized by write-downs charged to operations (valuation and presentation assertions)

5. Proper classification — To determine that the balances and related expenses are properly described and classified in the financial statements (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Obtain schedules of deferred charges and intangibles. (1)	______	______	______
1. Test arithmetic accuracy of the schedules. (1)	______	______	______
2. Agree balances to the trial balance. (1)	______	______	______
C. Examine documentation supporting major transactions during the year. (2)	______	______	______
D. Review capitalization and amortization policies for reasonableness and consistency with prior years. (2)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XI. DEFERRED CHARGES AND INTANGIBLES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
E. Test amortization calculations as considered necessary. (3)	______	______	______
F. Determine if there has been a permanent impairment of carrying amounts. (4)	______	______	______
G. Determine that required disclosures have been made in the financial statements. (5)	______	______	______
H. Additional procedures:			
____________________			
____________________			
____________________			
____________________	______	______	______

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XII. ACCOUNTS PAYABLE

Objectives:

1. Existence — To determine that accounts payable represent authorized current obligations (existence and obligations assertions)

2. Classification — To determine that amounts included in accounts payable are properly classified (presentation assertion)

3. Completeness — To determine that accounts payable include all significant current obligations (completeness assertion)

4. Amounts — To determine that accounts payable are properly stated (valuation assertion)

5. Disclosure — To determine that accounts payable are properly disclosed in the financial statements including any liabilities secured or collateralized by pledged assets (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the following to determine the nature, timing and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Obtain a schedule of accounts payable as of the balance-sheet date. (1, 3)	______	______	______
1. Test the arithmetic accuracy of the schedule. (1, 3)	______	______	______
2. Agree the total to the trial balance. (1, 3)	______	______	______
3. Make sure the schedule (or schedules) shows separately amounts due to:			
a. Trade creditors (2)	______	______	______
b. Officers (2)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XII. ACCOUNTS PAYABLE (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
c. Employees (coordinate with Section XVIII.) (2)	______	______	______
d. Related companies (coordinate with Section XVIII.) (2)	______	______	______
e. Others (2)	______	______	______
C. Trace all balances over $______ and ______ items under that amount (based on the appropriate sample size selection form) to supporting documents such as invoices. Examine support to determine if the amount was owed at the balance-sheet date. For example, see that goods were received or the obligation incurred at that date. (Consider whether other data sources should be considered such as a file of receiving reports.) (Under System A, the amounts can be traced to a subledger instead.) (4)	______	______	______
D. Perform a search for unrecorded liabilities. Trace selected disbursements from the cash disbursements journal and the purchases journal after the balance-sheet date to supporting documentation to determine whether the obligation was incurred before the balance sheet date. If so, determine whether the amount was included in accounts payable or otherwise accrued. The scope for this test should be as follows:			
1. For the period of _____ days after the balance-sheet date, all payments over $______ and ______ payments below that amount. (3)	______	______	______
2. For the next _____ days after the balance-sheet date, all payments over $______ and ______ payments below that amount. (3)	______	______	______
3. For all payments after that until the end of fieldwork, all payments over $______ and ______ payments below that amount. (It is common for the selection thresholds to increase for each subsequent test.) (3)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XII. ACCOUNTS PAYABLE (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
4. Inspect files of unprocessed invoices and vendors' statements relating to goods and services received before year-end. (3)	______	______	______
E. Consider mailing confirmations to selected creditors. (3)	______	______	______
F. Consider whether reclassification of debit balances is necessary. (5)	______	______	______
G. Determine that last receipts for the year (obtained at the physical inventory) are shown in accounts payable and the first receipts for the year aren't. (1, 3)	______	______	______
H. Additional procedures:			
______________________			
______________________			
______________________			
______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XIII. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Objectives:

1. Amount — To determine that the amounts represent the obligations of the client at the balance-sheet date (existence and obligations assertions)

2. Subsequent payment — To determine that the amounts shown as liabilities represent the amounts expected to be paid in the subsequent year (valuation assertion)

3. Completeness — To determine that the expense accounts include all costs and expenses applicable to the period (completeness assertion)

4. GAAP — To determine that accrued expenses and other liabilities, including current and deferred income taxes, are presented in conformity with GAAP and required disclosures are made (presentation assertion)

Note: The audit program presumes that all the amounts in this caption are material. It is likely that some will not be; and judgment should be used to decide whether to omit certain procedures.

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Customer Security Deposits. (This account is often tested in conjunction with the work on customer accounts receivable.)			
1. Obtain a schedule of all customers who have made deposits on delivery of vehicles as of the balance-sheet date. (1, 3)	______	______	______
a. Test the arithmetic accuracy of the schedule. (1)	______	______	______
b. Agree the balance to the trial balance. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIII. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
2. Determine if there are any customer deposits more than 30 days old. Inquire as to the reasons and status for such amounts. (1)	______	______	______
3. Trace subsequent liquidation of these deposits to cash disbursements or sales contracts completed and related cash receipts or cash disbursements after the balance-sheet date. (2, 4)	______	______	______
4. Compare the balance to the previous year's and investigate any significant fluctuation. (3)	______	______	______
C. Lien Payoffs			
1. Obtain a schedule of all liens on vehicles accepted as trade-ins as of the balance-sheet date. (1)	______	______	______
a. Test the arithmetic accuracy of the schedule. (1)	______	______	______
b. Agree the balance to the trial balance. (1)	______	______	______
2. Determine that the amounts arose from actual trade-ins and that the dealership is obligated to pay off the amounts. (1, 4)	______	______	______
3. Examine evidence of subsequent payoffs to the financing institutions. Inquire as to the reason for any payment more than a few days after the balance-sheet date. (2)	______	______	______
4. Compare the balance to the prior year's and determine the reason for any significant difference. (3)	______	______	______
D. Accrued Salaries			
1. Obtain a schedule of accrued salaries as of the balance-sheet date. (1)	______	______	______
a. Test the arithmetic accuracy of the schedule. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIII. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
b. Agree the balance to the trial balance. (1)	_____	_____	_____
2. Compare the balance to the first payroll of the subsequent year. (2, 3, 4)	_____	_____	_____
E. Accrued Salesmen's Commissions			
1. Obtain a schedule of all unpaid salesmen's commissions as of the balance-sheet date. (1, 3)	_____	_____	_____
a. Test the arithmetic accuracy of the schedule. (1)	_____	_____	_____
b. Agree the balance to the trial balance. (1)	_____	_____	_____
2. Compare the schedule to a list of salesmen who are entitled to receive commissions. (3)	_____	_____	_____
3. Examine subsequent payments to salesmen whose accrued commissions were in excess of $ _______ and ______ below that amount (or examine ________ subsequent payments to salesmen). (2)	_____	_____	_____
4. Compare the year-end balance to the prior year's and determine the reasons for any significant differences. (1, 3, 4)	_____	_____	_____
F. Extended Warranty and Credit Life Insurance Payable			
1. Obtain a schedule of payments for extended warranty and credit life policies sold but not remitted to carriers (less the dealership's commission) as of the balance-sheet date. (1, 3)	_____	_____	_____
a. Test the arithmetic accuracy of the schedule. (1)	_____	_____	_____
b. Agree the balance to the trial balance. (1)	_____	_____	_____
2. Determine if any amounts are more than 30 days old. Inquire as to the reasons for any old or unusual amounts and assess the effect of the response. (1)	_____	_____	_____

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIII. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
3. Examine subsequent payment of amounts to carriers. (2)	______	______	______
4. Compare the year-end balance to the prior year's and determine the reasons for any significant differences. (1, 3, 4)	______	______	______
G. Accrued Payroll Taxes			
1. Obtain a schedule of payments for payroll taxes accrued as of the balance-sheet date. (1, 3)	______	______	______
a. Test the arithmetic accuracy of the schedule. (1)	______	______	______
b. Agree the balance to the trial balance. (1)	______	______	______
2. Agree the amounts to appropriate payroll tax returns. (1, 3)	______	______	______
3. Trace accrued amounts to subsequent cash disbursements. (2)	______	______	______
4. Discuss with the client its auto use policy, demonstrator agreements, similar arrangements, and fringe benefit reporting requirements. Consider whether non-compliance with the requirements indicates the possibility of potential payroll tax penalties. (3)	______	______	______
5. Compare the year-end balance to the prior year's and determine the reasons for any significant differences. (1, 3, 4)	______	______	______
H. Sales Tax Payable			
1. Obtain a schedule of sales taxes collected but unpaid as of the balance-sheet date. (1, 3)	______	______	______
a. Test the arithmetic accuracy of the schedule. (1)	______	______	______
b. Agree the balance to the trial balance. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIII. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
2. Agree amount to sales tax or DMV report due during the subsequent month. (1, 3)	______	______	______
3. Examine subsequent payment of sales tax due. (2)	______	______	______
4. Compare the year-end balance to the prior year's and determine the reasons for any significant differences. (1, 3, 4)	______	______	______
I. Tax, Tag, and Title Payable			
1. Obtain a schedule of payments for tax, title, and tags received from customers but not yet paid to the DMV as of the balance-sheet date. (1, 3)	______	______	______
a. Test the arithmetic accuracy of the schedule. (1)	______	______	______
b. Agree the balance to the trial balance. (1)	______	______	______
2. Trace payments made shortly after year end to supporting documentation to determine that the payments relate to sales made before year end. Determine the reasons for any payments made more than two weeks after year end. (These should relate to vehicle sales observed in the sales cutoff data obtained at the physical inventory.) (1, 2)	______	______	______
3. Compare the year end balance to the prior year's and determine the reasons for any significant differences. (1, 3, 4)	______	______	______
J. Accrued Income Taxes			
1. Prepare or obtain a tax calculation based on the client's pretax income after adjustments proposed and booked as a result of this financial statement audit. (1, 3)	______	______	______
2. Account for any book/tax basis differences. Maintain a detailed description of book/tax permanent and temporary differences. (1, 3)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIII. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
a. Compute, or obtain and test the client's computation of, deferred tax assets and liabilities to determine conformity with SFAS No. 109. (1, 3)	______	______	______
b. For deferred tax assets, determine the likelihood that all or part of the recorded amount will not be realized. (1)	______	______	______
c. If it is determined that it is more likely than not that all or part of the deferred tax asset will not be realized, evaluate the adequacy of the valuation allowance by performing the following:			
(i) Review and test the process used by management to develop the estimate, or develop an independent expectation of the estimate, to corroborate the reasonableness of management's estimate. (1)	______	______	______
(ii) Determine whether any subsequent events or transactions have occurred prior to the completion of field work that could affect the adequacy of the valuation allowance. (1)	______	______	______
3. Complete tax accrual checklists, as appropriate. (1, 3)	______	______	______
4. Obtain tax department review of the income tax provision. (1, 3)	______	______	______
5. Determine that the following items are adequately disclosed in the financial statements:			
a. Amounts currently payable. (4)	______	______	______
b. Classification of deferred taxes. (4)	______	______	______
c. Tax credits. (4)	______	______	______
d. Benefits of loss carryovers. (4)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIII. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
e. Rate adjustments or other changes. (4)	______	______	______
6. Prepare or test the calculation of state income taxes. Consider tax liabilities for all states in which the client does business. (1, 3, 4)	______	______	______
K. Accrued Bonuses			
1. Obtain a schedule of employee bonuses accrued but unpaid as of the balance-sheet date. (1, 3)	______	______	______
a. Test the arithmetic accuracy of the schedule. (1)	______	______	______
b. Agree the balance to the trial balance. (1)	______	______	______
2. When applicable, trace bonuses to board of directors' authorizations. (1)	______	______	______
3. Trace accrued bonuses to subsequent payment, if made before the end of fieldwork. (2)	______	______	______
4. Determine that accruals are paid within the time period required for deductibility under income tax law. (1)	______	______	______
5. Compare the year end balance to the prior year's and determine the reasons for any significant differences. (1, 3, 4)	______	______	______
L. Accrued Pensions			
1. Obtain a schedule of accrued pensions as of the balance-sheet date. (1, 3)	______	______	______
a. Test the arithmetic accuracy of the schedule. (1)	______	______	______
b. Agree the balance to the trial balance. (1)	______	______	______
2. Determine whether any changes were made to the pension plan during the year. (1, 3, 4)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIII. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
3. Determine whether the pension calculations are based on the same assumptions as in prior years. Consider the reasons for any changes. (1, 3, 4)	______	______	______
4. Confirm pension plan expense and accruals with actuaries or trustees. Determine and document:			
a. The professional competence of the actuary. (1, 3)	______	______	______
b. The actuary's reputation. (1, 3)	______	______	______
c. That the actuary understands we will use the actuarial report to corroborate management's representations in the financial statements. (1, 3)	______	______	______
d. The actuary's relationship, if any, with the client (see SAS No. 73, paragraph 9. (1, 3)	______	______	______
e. Whether the actuarial information agrees with the client's records. (1, 3)	______	______	______
f. The accounting and funding policies and employee groups covered by the plan. (1, 3, 4)	______	______	______
g. Whether adequate provision has been made for current obligations. (3)	______	______	______
h. Whether sufficient information is provided for disclosures required under GAAP. (4)	______	______	______
5. Compare the year-end balance to the prior year's and determine the reasons for any significant differences. (1, 2, 3, 4)	______	______	______
M. Accrued Vacation and Sick Pay			
1. Obtain a schedule(s) of accrued vacation and sick pay as of the balance-sheet date. (1, 3)	______	______	______
a. Test the arithmetic accuracy of the schedule(s). (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIII. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
b. Agree the balance(s) to the trial balance. (1)	______	______	______
2. Determine the reasonableness of the amounts based on the company's vacation and sick pay policies, salary expense, and other matters such as employee turnover. (1, 3)	______	______	______
3. Compare the year-end balance to the prior year's and determine the reasons for any significant differences. (1, 2, 3, 4)	______	______	______
N. Other			
1. Obtain schedules of the details as of the balance-sheet date. (1, 3)	______	______	______
a. Test the arithmetic accuracy of the schedules. (1)	______	______	______
b. Agree the balances to the trial balance. (1)	______	______	______
2. Agree amounts of significant items to invoices or other documentation indicating they related to the period before year end. (1)	______	______	______
3. Agree amounts to payments made after year end. Remember that some items, such as accrued contributions, must be paid within $2^{1}/_{2}$ months of year end to be deductible under income tax law. (2)	______	______	______
4. Compare the year-end balance to the prior year's and determine the reasons for any significant differences. (1, 3, 4)	______	______	______
O. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XIV. WHOLESALE FINANCE (FLOOR PLAN) LIABILITY

Objectives:

1. Existence — To determine that the debt is authorized, properly classified, and presented in the financial statements (existence, obligations, and presentation assertions)

2. Amount — To determine that the debt is recorded in the correct amount (valuation assertion)

3. Completeness — To determine that all amounts owed for vehicle acquisitions are included (completeness assertion)

4. Out of trust conditions — To determine that financing is paid off within the prescribed time after vehicles are sold, failures to do so can result in a finance company calling all loans (presentation assertion)

5. Expense — To determine that related interest expense is properly recorded (existence and completeness of expenses and accrued liabilities)

6. Disclosure — To determine that the financial statements adequately disclose restrictive covenants and encumbrances (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Prepare or obtain a reconciliation of the wholesale finance liability to financing institution's floor plan statement. (1, 2, 3)	______	______	______
1. Test the arithmetic accuracy of the schedule. (1)	______	______	______
2. Agree the totals to the trial balance. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIV. WHOLESALE FINANCE (FLOOR PLAN) LIABILITY (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
3. Trace payoffs not reflected in the creditor's statements to a copy of the check. Also determine that the payoff is reflected in the subsequent creditor's statement. Trace vehicles in transit to inventory list and subsequent creditor's statement. (3)	______	______	_____
4. Trace ______ items from client records to the creditors statement and _____ items from the creditor's statement to the client's records. (1, 3)	______	______	_____
5. Scan the reconciliation for unusual items. (1, 2, 3)	______	______	_____
C. Confirm the amount of debt and terms with lenders. If confirmations are not returned, send second requests. (If responses to second requests are not received perform alternative procedures, such as examining subsequent payments and bank statements.) (2)	______	______	_____
D. Determine if any out of trust situations exist with regard to floor plan liability. If any, indicate amount and date of subsequent payment for report disclosure. (4)	______	______	_____
E. Obtain information on collateral; usually collaterized by the vehicles themselves, contract rights, or the stockholders. Also obtain maximum amount of borrowing allowable (amount or in number of vehicles). (6)	______	______	_____
F. Reconcile confirmation responses to the client's records. Common reconciling items are vehicles in stock not yet recorded by the bank and payoffs in transit not yet received by the bank. (2)	______	______	_____
G. Compare the debt schedule to the vehicle inventory. Consider the following factors:			
1. Vehicles for which no floor plan liability is recorded. (3)	______	______	_____
2. Debt for which no vehicles are on hand (out of trust). (The dealership is permitted a specified time after sale in which payment must be made.) (4)	______	______	_____

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIV. WHOLESALE FINANCE (FLOOR PLAN) LIABILITY (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
3. The reasonableness of the amount of debt in relation to the value of each vehicle. (2)	______	______	______
H. Test interest expense and accrued interest for reasonableness. (5)	______	______	______
I. Agree accrued interest, tested above, to subsequent month's cash disbursement or floor plan interest billing. (5)	______	______	______
J. Review compliance with restrictive covenants of loans. (6)	______	______	______
K. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XV. NOTES PAYABLE AND LONG-TERM DEBT

Objectives:

1. Completeness — To determine that all notes payable have been recorded (completeness assertion)

2. Existence — To determine that recorded liabilities are bona fide obligations (existence, valuation, and obligations assertions)

3. Restrictions — To determine that all restrictions and covenants imposed by the debt instruments are adhered to and adequately disclosed (presentation assertion)

4. Classification — To determine that debt is properly classified as long-term or short-term (presentation assertion)

5. Interest — To determine that interest expense and accrued interest payable are properly recorded (existence, completeness, valuation, and obligations assertions for expenses and accruals)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
1. Preliminary analytical procedures.	______	______	______
2. All-Substantive Approach Questionnaire or Internal Controls Questionnaire.	______	______	______
3. Tests of Controls Program.	______	______	______
B. Prepare or obtain a schedule of other notes payable showing amount due, terms, and accrued interest as of the balance-sheet date. (1, 2)	______	______	______
1. Test the arithmetic accuracy of the schedule. (2)	______	______	______
2. Agree balances to the trial balance. (2)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XV. NOTES PAYABLE AND LONG-TERM DEBT (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
C. Confirm the amount of debt and terms with lenders. Confirmations should also be sent for any obligations that existed during the year but are shown as paid off at year end. If confirmations are not returned, send second requests. (If responses to second requests are not received perform alternative procedures, such as examining subsequent payments and bank statements.) (1, 2)	______	______	______
D. Consider whether the results of the search for unrecorded liabilities indicate unrecorded notes or long-term debt. (1)	______	______	______
E. Review minutes of board of directors meetings to determine whether any new debt is properly authorized. (2)	______	______	______
F. Examine evidence, such as canceled notes, for notes paid off during the year. (1)	______	______	______
G. Review loan agreements and determine that dealership is in compliance with restrictive provisions. (3)	______	______	______
H. Determine whether the covenants and any assets pledged are adequately disclosed in the financial statements. (3)	______	______	______
I. Determine whether the long- and short-term portions of debt are properly disclosed in the financial statements. (4)	______	______	______
J. Determine whether the yearly maturities of long-term debt are properly disclosed in the financial statements. (4)	______	______	______
K. Test interest expense and accrued interest for reasonableness. (5)	______	______	______
L. Consider the need to impute interest on notes, if interest rates are unreasonable. (Coordinate with the tests of interest expense done in Section XVII.) (5)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XV. NOTES PAYABLE AND LONG-TERM DEBT (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
M. Additional procedures:			
____________________			
____________________			
____________________			
____________________	______	______	______

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XVI. STOCKHOLDERS' EQUITY

Objectives:

1. Authorization and classification — To determine that all transactions and commitments are properly authorized and classified (all assertions)

2. Recognition and cutoff — To determine that all equity amounts are recorded at the correct amounts in the proper period (valuation and presentation assertions)

3. GAAP — To determine that all capital accounts are presented in conformity with GAAP (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Obtain a schedule detailing the components of the capital accounts as of the balance-sheet date and any activity for the year. (2)	______	______	______
1. Test the arithmetic accuracy of the schedule. (2)	______	______	______
2. Agree the balance to the trial balance. (2)	______	______	______
B. Examine the open stubs in the stock certificate book to determine the amount of outstanding stock. (1)	______	______	______
1. Determine that surrendered certificates have been accounted for and canceled. (1)	______	______	______
2. Agree the total outstanding to the stockholders' ledger. (1)	______	______	______
C. Compare the year-end balance of capital stock to the prior year's and determine the reasons for any significant differences. (2, 3)	______	______	______
D. Update permanent file for each class of capital stock showing:			
• Number of shares authorized. (1)	______	______	______
• Par or stated values. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XVI. STOCKHOLDERS' EQUITY (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
• Redemption or liquidation values. (1)	______	______	______
• Dividend rates. (1)	______	______	______
• Participation and conversion privileges. (1)	______	______	______
• Voting rights. (1)	______	______	______
• Other special privileges. (1)	______	______	______
E. Inspect the articles of incorporation by-laws, partnership agreement, etc. and update the permanent file for any matters of audit significance. (1)	______	______	______
F. Trace any treasury stock transactions during the year to supporting documentation, such as cash receipts or disbursements, agreements, or similar sources. (2)	______	______	______
G. Inspect treasury stock certificates on hand. (1)	______	______	______
H. Review activity in retained earnings. (2, 3)	______	______	______
1. Determine that retained earnings have been increased for the year's net income. This may require adjustment in some accounting systems, when the accounting system is designed for a calendar year and the client uses a fiscal year. (3)	______	______	______
2. Agree dividends paid and declared to board of directors minutes and vouch the payments. (1)	______	______	______
3. Determine the appropriateness of any other changes in retained earnings. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XVI. STOCKHOLDERS' EQUITY (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
I. Additional procedures:			
______________________			
______________________			
______________________			
______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XVII. INCOME AND EXPENSE ACCOUNTS

Objectives:

1. Revenue — To determine that all revenue earned during the year was recorded and that all revenue recorded represents amounts earned during the year (existence and completeness assertions)
2. Matching — To determine that costs and expenses are properly matched with revenues and are applicable to the current year (existence, completeness, and valuation assertions)
3. Classification — To determine that reported costs and expenses are appropriately and consistently classified and that unusual and nonrecurring transactions have been properly classified and adequately described (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
Most of the audit tests done under this caption are analytical procedures. When such a procedure indicates a variation from the auditor's expectation (which might mean an unexpected change from year to year or the lack of a change when one should be expected) the auditor should discuss the reason for the variation with client management. The auditor should consider the reasonableness of the explanation and then obtain corroborating support for it.			
The comparisons can be done on year-to-year data for the dealership, on industry data, or on local groups of dealers. It is often helpful to look at trends in addition to single year data.			
A. Comparison of income statement account balances with information from prior period(s).			
1. Obtain the following data by month for *each department*:			
a. Number of units sold. (1)	______	______	______
b. Total dollar sales. (1)	______	______	______
c. Cost of sales. (2)	______	______	______
d. Gross profit. (2)	______	______	______
e. Average sales price per unit. (1)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XVII. INCOME AND EXPENSE ACCOUNTS (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
f. Average gross profit per unit. (2)	______	______	______
g. Gross profit percentage. (2)	______	______	______
2. Examine monthly fluctuations and determine the reasons for significant ones. (3)	______	______	______
3. Compare current year totals by department with prior year(s) and obtain explanations for significant variations. (3)	______	______	______
B. Comparison of income statement account balances with anticipated or predicted results.			
1. Compare the following actual data with the client's budgets and determine the reasons for any significant differences:			
a. Number of units sold. (1)	______	______	______
b. Total sales in dollars. (1)	______	______	______
c. Cost of sales. (2)	______	______	______

Note: This procedure is only useful if the client has a budgeting system that relies on good data, undergoes review by those at appropriate levels of authority, and produces budgets that are neither overly optimistic nor pessimistic. If the client's budgeting system is not characterized by these attributes, this procedure will not yield useful results. In that case, the quality of evidence that these analytical procedures provide will be reduced and more rigorous testing may be required in other steps in this area.

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XVII. INCOME AND EXPENSE ACCOUNTS (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
C. Relationships between elements of the financial statements.			
1. Calculate the following ratios for the current year and prior year(s):			
a. Current ratio. (2, 3)	______	______	______
b. Quick ratio. (2, 3)	______	______	______
c. Sales/receivables. (1)	______	______	______
d. Days' sales in receivables*. (1)	______	______	______
e. Cost of sales/inventory. (2)	______	______	______
f. Days' sales in inventory*. (1)	______	______	______
g. Cost of sales/accounts payable. (2)	______	______	______
h. Days' purchases in payables. (2)	______	______	______
i. Sales/working capital. (1)	______	______	______
j. Earnings before interest and taxes/interest. (2, 3)	______	______	______
k. Cash flow/current maturities. (2)	______	______	______
l. Fixed assets/net worth. (2)	______	______	______
m. Debt/net worth. (2)	______	______	______
n. Pretax income/net worth. (2)	______	______	______
o. Pretax income/total assets. (2)	______	______	______
p. Sales/fixed assets. (1)	______	______	______
q. Sales/total assets. (1)	______	______	______
r. Depreciation plus amortization/fixed assets. (2)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XVII. INCOME AND EXPENSE ACCOUNTS (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
s. Officers' compensation/sales. (2)	______	______	______
* Other areas of the audit program already call for calculation of these ratios; it might be more efficient to coordinate this work.			
2. Compare the current and prior-year ratios and obtain explanations for significant variations. (3)	______	______	______
D. Comparison of financial information with industry information.			
1. Calculate the following items as a percent of sales.			
a. Gross profit (2)	______	______	______
b. Operating expense (2)	______	______	______
c. Operating profits (2)	______	______	______
d. Other income and expense (1, 2)	______	______	______
e. Profit before taxes (2)	______	______	______
2. Compare these data to comparable industry data. (2)	______	______	______
3. Analyze any significant differences between the company's and industry's data. (3)	______	______	______
E. Analyze the following expense accounts. Examine supporting documentation, when appropriate.			
1. Analyze legal and professional fees for information about pending lawsuits, contracts, agreements, or other matters that might indicate possible contingent liabilities or other information with accounting or audit significance. (3)	______	______	______
2. Analyze rents for possible undisclosed lease obligations or license agreements. (3)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XVII. INCOME AND EXPENSE ACCOUNTS (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
3. Analyze charitable contributions for proper authorization of significant amounts. (3)	_______	_______	_______
4. Analyze travel and entertainment for:			
• appropriate support and authorization (3)	_______	_______	_______
• unreasonable amounts (3)	_______	_______	_______
• personal expenses (3)	_______	_______	_______
5. Analyze miscellaneous or other "catchall" expense accounts for an understanding of the nature of such charges. (3)	_______	_______	_______
6. Analyze repairs and maintenance to identify items that should have been capitalized. (Coordinate with work done in Section IX., Step C.4.) (3)	_______	_______	_______
a. Select all items over $_______ and _______ items under that amount for testing. (3)	_______	_______	_______
b. Determine reasonableness of the accounting treatment. (3)	_______	_______	_______
F. Additional procedures:			
_______________________________			
_______________________________			
_______________________________			
_______________________________	_______	_______	_______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XVIII. RELATED-PARTY TRANSACTIONS

Objectives:

1. Proper recognition — To identify related parties and related-party transactions (existence and completeness assertions)

2. Proper recording — To determine that such transactions are properly recorded (rights and valuation assertions)

3. Proper disclosure — To determine that GAAP disclosure has been made (presentation assertion)

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Make inquiries of management about related parties, obtain related-party confirmation if applicable, and inquire about any recorded or unrecorded transactions during the year. (1)	______	______	_____
B. Obtain names of stockholders and directors for evidence of related-party transactions. (1)	______	______	_____
C. Review last year's working papers for evidence of related-party transactions. (1)	______	______	_____
D. Ask predecessor auditors, if any, about related parties. (1)	______	______	_____
E. Investigate transactions with major customers, suppliers and lenders for undisclosed relationships. (1)	______	______	_____
F. Review minutes of stockholders' and directors' meetings for evidence of related parties. (1)	______	______	_____
G. Be alert for potential related-party transactions while examining confirmations of receivables and payables, large unusual transactions and attorneys' letters. (1)	______	______	_____
H. Obtain a list of major customers, amounts of sales during the year and amounts of receivables at year end for undisclosed relationships. Agree to detail client records. (1)	______	______	_____
I. Examine supporting documents of significant related-party transactions to determine:			

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XVIII. RELATED-PARTY TRANSACTIONS (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
1. Business purpose. (2)	______	______	______
2. Board of directors' approval. (2)	______	______	______
3. Reasonableness and consistency of amounts to be disclosed. (2)	______	______	______
4. Financial capabilities of related parties. (2)	______	______	______
5. Consider confirming balances due from/to related parties. (2)	______	______	______
J. Determine that related-party relationships and transactions are disclosed in conformity with GAAP. (3)	______	______	______
K. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XIX. ILLEGAL ACTS

Objectives:

1. To determine whether there are any material illegal acts that have a direct effect on the financial statements (existence, completeness, and disclosure assertions)

2. To consider whether there are any material illegal acts that have an indirect effect on the statements but need to be disclosed (disclosure assertion). Laws that might have an indirect effect include:

   - Environmental laws (Resource Conservation Act of 1976, 1980 Superfund Act, Clean Air Act)
   - Cash reporting regulations (all cash receipts of more than $10,000 must be reported to the IRS on Form 8300)
   - Vehicle registration laws
   - Occupational Safety and Health Administration (OSHA) regulations.

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Inquire of management regarding the company's:			
1. Compliance with laws and regulations. (1, 2)	______	______	______
2. Policies regarding the prevention of illegal acts. (1, 2)	______	______	______
3. Use of directives and periodic representations obtained from management at appropriate levels of authority regarding compliance with laws and regulations. (1, 2)	______	______	______
B. If specific information provides evidence that an illegal act may have occurred, obtain additional information to evaluate the act from a level of management above those involved or, if necessary, the client's attorneys. (1, 2)	______	______	______
C. Consider whether additional procedures need to be applied to understand and evaluate the act. (1, 2)	______	______	______
D. If it is concluded that an illegal act has occurred:			
1. Determine the effect on the financial statements, including disclosures. (1, 2)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XIX. ILLEGAL ACTS (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
2. Determine the audit committee, or if there is none, a body with equivalent authority and responsibility, is adequately informed of the act, the circumstances of its occurrence, and its effect on the financial statements. (1, 2)	______	______	______
E. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XX. LITIGATION, CLAIMS, AND ASSESSMENTS

Objective:

To ensure that the financial statements adequately reflect all material asserted litigation, claims, and assessments and those unasserted ones that are probable of assertion (all assertions).

Procedures (Objective(s))	Done By	Date	W/P Ref.
A. Consider whether the minutes of the board of directors' meetings, contracts, correspondence from governmental agencies, bank confirmations, correspondence and invoices from lawyers, or other documents indicate the existence of possible litigation, claims, or assessments.	______	______	______
B. Send a standard inquiry letter to all lawyers consulted by the client to corroborate information regarding asserted litigation, claims, and assessments and unasserted litigation, claims, and assessments that are probable of assertion.	______	______	______
C. Consider the adequacy of the lawyers' replies and the effect of any limitation on their responses.	______	______	______
D. Consider the adequacy of financial statement disclosure for contingencies.	______	______	______
E. Consider whether there are contingent liabilities regarding environmental matters.	______	______	______
1. Inquire of management whether the company or any of its subsidiaries has been designated a potentially responsible party by the Environmental Protection Agency or otherwise has a high-risk exposure to environmental liabilities.	______	______	______
2. Consider other possible indicators of increased risk of environmental liability, such as:			
a. Participation in a real estate transaction or corporate merger involving properties with environmental risks.	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XX. LITIGATION, CLAIMS, AND ASSESSMENTS (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
b. The purchase of land at a price significantly below local market prices.	______	______	______
c. The acquisition of new or increased insurance coverage against environmental risks or liability to third parties.	______	______	______
F. Determine whether the entity has any commitments with off-balance-sheet risk (e.g., financial guarantees and letters of credit at floating rates). For any such commitments complete step G. of the Investments Securities Tests of Balances Audit Program.	______	______	______
G. Additional procedures:			
________________________________			
________________________________			
________________________________			
________________________________			

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM

XXI. RISKS AND UNCERTAINTIES

Financial Statement Assertion

Presentation and disclosure (P)

Objectives:

- GAAP conformity—To determine that disclosure of certain significant estimates and certain concentrations is in conformity with GAAP consistently applied. (assertion P)

Procedures (Objective(s))	Done by	Date	W/P Ref.
A. Obtain or prepare a listing of any estimates used in determining the carrying values of assets and liabilities and gain and loss contingencies that are sensitive to change. Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate. (P)	______	______	______
B. Consider whether it is at least reasonably possible that a material change in the estimate will occur in the near term. (P)	______	______	______
C. If such a situation is identified, review support for the calculation of the effect of the change. (P)	______	______	______
D. Obtain or prepare a listing of the following types of concentrations, if any, that existed at the balance-sheet date and that make the entity vulnerable to risk of near-term severe impact (severe impact is a higher threshold than materiality, but less than catastrophic). Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate:			
• volume of business transacted with a particular customer, supplier, or lender (P)	______	______	______
• revenues from particular products or services (P)	______	______	______

AUTO DEALERSHIP TESTS OF BALANCES AUDIT PROGRAM
XXI. RISKS AND UNCERTAINTIES (Continued)

Procedures (Objective(s))	Done By	Date	W/P Ref.
• available sources of supply of materials, labor or services, or of licenses or other rights used in operations (P)	______	______	______
• market or geographic area in which the entity conducts its operations (P)	______	______	______
E. Determine whether it is at least reasonably possible that an event will occur in the near term that would cause the severe impact. (P)	______	______	______
F. Determine whether disclosures required by SOP 94-6 are completely and accurately included in the financial statements. (Refer to the Auto Dealership Financial Statement Disclosure and Auditor's Report Checklists in Chapter 11.) (P)	______	______	______
G. Additional procedures: ______________________ ______________________ ______________________ ______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

Accounting Principles
& Practices

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ACCOUNTING PRINCIPLES AND PRACTICES

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ACCOUNTING PRINCIPLES AND PRACTICES

8.000 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

8.001 Generally accepted accounting principles (GAAP) that apply to auto dealers are those applicable to any other commercial entity. This chapter does not attempt to explain GAAP in detail. Rather, it focuses on how GAAP is applied to the particular circumstances found in auto dealerships.

8.002 Statement on Auditing Standards (SAS) No. 69, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report*, establishes the sources of GAAP and their relative importance. These apply to all auto dealers that present their financial statements in conformity with GAAP, regardless of the accountant's level of service. Thus, the same GAAP applies whether the dealership's financial statements are audited, reviewed or compiled. In FASB Statement No. 111, *Recission of FASB Statement No. 32 and Technical Corrections*, the FASB explicitly recognized SAS No. 69's hierarchy of GAAP.

8.003 "Generally accepted accounting principles" is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures.

8.004 The determination that a particular accounting principle is generally accepted may be difficult because no single reference source exists for all such principles. Nonetheless there is a body of knowledge that accountants need to consider when deciding whether a given accounting principle has general acceptance in the circumstances.

8.005 SAS No. 69 established a hierarchy of sources of GAAP. The proper accounting in a given circumstance should be determined from those sources.

- When an issue is not addressed in one level of the hierarchy it may be necessary to look to the next lower level.
- When sources on different levels disagree, the treatment in the higher level should be used unless it can be justified that the treatment specified in a lower level better presents the substance of the transaction in the circumstances.

Exhibit 1 presents the hierarchy in SAS No. 69.

Exhibit 1

GAAP Hierarchy Summary

Established Accounting Principles	1. FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins
	2. FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position
	3. Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins
	4. AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent
Other Accounting Literature†	5. Other accounting literature, including FASB Concepts Statements; APB Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles

† In the absence of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.

8.006 The highest level of the hierarchy of GAAP comprises officially established accounting principles. The sources of such principles are: FASB Statements of Financial Accounting Standards, FASB Interpretations, Accounting Principles Board Opinions, and AICPA Accounting Research Bulletins.

8.007 The second level of the hierarchy are pronouncements of expert bodies of accountants that exposed the pronouncement for public comment before issuing it. This level comprises: FASB Technical Bulletins, AICPA Audit and Accounting Guides, and AICPA Statements of Position.

8.008 The third level consists of pronouncements of expert bodies of accountants who have not subjected the pronouncement to exposure before issuance. The following pronouncements constitute the third level: AICPA Accounting Standards Executive Committee Practice Bulletins and consensus positions of the FASB Emerging Issues Task Force.

8.009 The final level is composed of practices or pronouncements that are widely recognized as being generally accepted. It consists of AICPA accounting interpretations, FASB implementation guides (Qs and As), and practices that are widely recognized and prevalent either generally or in the industry.

8.010 When a particular situation is not discussed in one of the sources of established accounting principles, we may look to other accounting literature, depending on its relevance in the circumstances. Such literature includes: FASB Statements of Financial Accounting Concepts; APB Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; GASB statements, interpretations, and technical bulletins; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, or articles.

OCBOA

8.011 Auto dealerships sometimes present their financial statements on the tax basis of accounting, which is an other comprehensive basis of accounting (OCBOA). Dealers might choose this basis because it's more relevant to them than GAAP or because they want to avoid the more onerous GAAP disclosures and calculations.

8.012 SAS No. 62, *Special Reports*, establishes presentation and disclosure principles for the tax basis of accounting, as well as for the cash and modified cash bases. The Statement requires that:

- The summary of significant accounting policies discuss the basis of presentation and describe how that basis differs from GAAP, although the differences need not be quantified.
- The financial statements contain adequate disclosure. When the financial statements contain items that are the same, or similar to, those in GAAP financial statements similar disclosures are appropriate. Thus, disclosures regarding depreciation, long-term debt, and owners' equity should be similar to disclosures made in GAAP financial statements. Also, disclosure should be considered for items such as related-party transactions, restrictions on assets and owners' equity, subsequent events, and uncertainties.

8.100 APPLICATION TO AUTO DEALERSHIPS

8.101 The balance of this chapter discusses how GAAP apply to the unique operating aspects of automobile dealerships.

8.102 Exhibit 2 presents a general overview of a car dealership's accounting for vehicle purchases and sales for a car dealership. Later sections of this chapter describe how industry practices affect the carrying amounts and financial statement presentation for specific accounts.

Exhibit 2
Overview of Accounting for Vehicle Transactions

The following is an overview of the accounting for a vehicle purchase and sale.

1. *Purchase of a new vehicle.* Assume the invoice price is $14,000 and is subject to a 2% holdback.

Inventory — new cars	13,720	
Holdback receivable/ factory	280	
Floor plan note payable		14,000

2. *Payment of interest on the note payable.* The interest is paid monthly for the total outstanding floor plan notes.

Interest expense	100	
Cash		100

3. *Customer's completion of a contract to buy the vehicle.* Assume a deposit of $200 is received.

Cash	200	
Accounts receivable — customers		200

The account credited is sometimes called "customer deposits" or "vehicle receivables".

4. *Closing of the sale.* Assume the sales contract was for $16,000 with the following terms:

Cash, including deposit	$2,000
Trade-in allowance	2,000
Appraised value of trade-in	1,600
Financing provided by finance company	12,000
Fee to be received from finance company	180

The entries would be:

(a) *To record the revenue*

Cash	1,800	
Accounts receivable — customers	200	
Inventory — used cars	1,600	
Contracts in transit	12,000	
Due from finance company	180	
New car sales		15,600
Finance income		180

(b) *To record the cost of sale*

Cost of sales	13,720	
Inventory — new cars		13,720

5. *Payment of the note to floor plan finance company.* The first entry records payment of the floor plan note, the second records the transfer of the customer finance contract to the finance company.

(a) Floor plan note payable	14,000	
Cash		14,000
(b) Cash	12,000	
Contracts in transit		12,000

6. *Receipt of holdback from manufacturer.*

Cash	280	
Holdback receivable/factory		280

Sometimes, rather than receipt of cash the accounts payable to the manufacturer is debited.

7. *Receipt of fee from finance company.*

Cash	180	
Due from finance company		180

8.200 CASH

8.201 Auto dealers, like many organizations, often have several cash accounts: Petty cash, cash on hand (generally in the hands of the cashier), and cash in bank. Cash in bank, in turn, might consist of several bank accounts, including imprest accounts for such things as payroll. These present no unusual accounting issues.

Contracts in Transit

8.202 Auto dealers' financial statements also include *contracts in transit* under the cash caption even though the contracts are more akin to receivables. Contracts in transit represent the amount of sales proceeds to be provided by a finance company. These contracts arise when auto dealers assist their customers in obtaining financing by establishing relationships with financial institutions and prepare the paperwork for the loan. At the time of sales the customer executes a note and the dealer forwards the contract to the finance company for payment.

8.203 Contracts in transit represent the amount of the loan (excluding interest and credit life insurance charges) to be provided by the finance company. The account is credited when cash is received from the finance company. Contracts are rarely outstanding for more than seven to ten days. See Exhibit 2, transactions 4 and 5 for an illustration of accounting for contracts in transit.

8.204 Contracts in transit is also used when a dealership finances a purchase itself with the intention of selling the note to a finance company. In that case the account is reduced for any principal withheld by the financing institution.

Temporary Cash Investments

8.205 *Temporary cash investments* are often combined with cash in auto dealer financial statements. These are generally very liquid investments.

Disclosures

8.206 Common *disclosures* regarding cash items include:

- The dealership's policy for determining the items (for example, contracts in transit) to be treated as cash equivalents in the statement of cash flows.
- Any restrictions on cash, such as compensating balances, and, if appropriate, reclassification of such amounts as noncurrent.
- Significant concentrations of credit risk that arise from cash deposits in excess of insured limits as required by FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk.*
- The fair value of cash investments and contracts in transit in accordance with FASB No. 107, *Disclosures about Fair Market Value of Financial Instruments.* This disclosure should include the method and significant assumptions used to estimate fair value. Because of the short maturity of these instruments it is often sufficient merely to disclose that the carrying value approximates the fair value.

8.300 ACCOUNTS RECEIVABLE

8.301 Auto dealers' accounts receivable arise from vehicle sales, repairs, maintenance contracts, and various arrangements with manufacturers such as holdbacks. Many dealerships further subdivide these types of receivables.

Receivables Arising from Customer Transactions

8.302 **Vehicle Sales.** When customers finance their vehicle purchases, they can do so through a finance company or through the dealer. When the dealer processes the paperwork for a finance company, the financed portion of the sales price is recorded in contracts in transit — a cash account (see section 8.202). When the dealer itself provides the financing, the financed portion of the purchase price appears as a receivable to the dealer.

8.303 Customer receivables are often evidenced by notes. In such a case, the note is shown at face value. As payments are received by the dealership the note is reduced by the amount of the principal payment and interest income is recorded.

8.304 A note's interest rate must be appropriate. That is, the rate should approximate the rate independent borrowers and lenders would have negotiated in a similar circumstance. Generally, the appropriate rate should be at least equal to the rate at which the borrower could obtain similar financing.

8.305 APB Opinion 21, *Interest on Receivables and Payables,* states that when a note with a maturity of more than one year bears no interest or carries an unreasonable interest rate, an appropriate interest rate should be imputed to the note. That is, the future payment stream should be treated as if it included an appropriate interest rate. The face value of the note should be decreased by the imputed interest (a discount) if the appropriate rate is higher than the stated rate or increased (a premium) if lower.

8.306 The resulting discount or premium generally should be amortized using the *interest method.* Under the interest method, the interest received plus amortization recorded each year yields a constant interest rate on the outstanding balance from year to year. Thus, the amortization is combined with the stated interest to arrive at total interest income. Exhibit 3 illustrates the imputation of interest for a note and the resulting accounting entries.

Exhibit 3
Illustration of Imputed Interest Calculation and Accounting

Assume a dealership takes a note for $10,000 payable over 36 months in a vehicle sales transaction. The note bears interest at 4%, but a reasonable rate would be 9%.

Monthly payments would be $ 295.24
The present value of these payments at 9% would be $9,284.35

The entry to record the sale would be:

Note receivable	10,000.00	
Discount on note receivable		715.65
New car sales		9,284.35

The entry for the first month for example, would be:

Cash	295.24	
Discount on note	36.30	
Note receivable		261.91
Interest income		69.63

Under APB Opinion 21, the financial statements after the twelfth month would show the note at the net amount, $6,462.55. The financial statement notes would disclose the effective interest rate, 9%, and the face amount of the note, $6,798.86.

8.307 When a discount or premium is imputed, it should be reported on the balance sheet as a direct reduction of the note that gave rise to it. APB Opinion 21 also requires that the financial statements disclose the effective (that is, total) interest rate, and the face amount of the note.

8.308 If a dealership sells the notes to a bank or other financial institution, the accounting for the sale of the note depends on the terms of the sale. A significant issue is the extent the bank buying the note can look to the dealer for repayment if the customer defaults. The bank pays more for the note when the dealer provides it protection by assuming some or all of the risk of nonpayment.

8.309 When the note is sold *without recourse* the bank cannot look to the dealership for payment in the event of default. In that case the bank may discount the note significantly, depending on the bank's assessment of its credit risk based on evaluating the borrower's ability to repay the note.

8.310 When a note is sold *with recourse* the accounting may be more complex. FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse,* requires that three conditions be met for the transfer to the bank to be recognized as a sale (that is, transfer) of the note:

- the dealership must surrender control of the future economic benefits of the note (for example, it doesn't have the option to repurchase the note from the bank),
- the dealership's potential exposure for bad debts and collection costs can be reasonably estimated,
- the bank cannot require the dealership to repurchase the note except under the stated recourse provisions.

8.311 If the transfer meets all three criteria, the dealership can remove the note from its balance sheet. The dealership records the transfer as a sale. It then creates a reserve by accruing the probable uncollectibles as well as any adjustments that would result from customers' early payoffs of the notes, creating a reserve.

8.312 If the transfer does not meet all three criteria, the note remains a receivable on the balance sheet and the proceeds received from the bank are treated as a liability.

8.313 When transfers of receivables with recourse are treated as sales, FASB Statement 77 requires that the financial statements disclose the proceeds received by the dealer during the period.

8.314 FASB Statement No. 105 requires disclosure of the following when there are transfers of receivables *with recourse:*

- the face amount of outstanding receivables with recourse
- the credit and market risk of the notes
- the cash requirements of the notes
- significant accounting policies regarding the transfers
- the amount of accounting loss the dealership would incur if the customer failed to pay the note and the collateral was of no value
- The dealership's policy of requiring collateral and a brief discussion of the collateral supporting the notes.

8.315 When a dealership negotiates the customer's financing on behalf of a financial institution the dealership earns finance income. The finance income represents a portion of the spread between the finance company's base lending rate to customers (its "buy rate") and the interest rate negotiated between the dealership and the customer.

8.316 The dealership recognizes finance income when the note is executed and sent to the finance company. Exhibit 2, transactions 4 and 7 illustrate the accounting for the dealer reserve.

8.317 The actual amounts paid to the dealership varies based on the dealer's agreement with the finance company. Common payment terms include:

- Payment of the entire fee at once.
- Retention by the finance company of a portion of the notes outstanding (for example, 1% of all the notes currently owed to the finance company that emanated from the dealership) and immediate payment of any excess. This retained portion is referred to as "finance reserve."

8.318 If the customer defaults on the note or pays it off early the finance company reduces the dealer reserve by a proportionate amount, generally by netting the reduction against future payments or against amounts the finance company may have held for such purposes. Accordingly, the dealership should normally establish a reserve for these "chargebacks," that is, the amount of finance income that will be ultimately uncollectible.

8.319 The reserve for chargebacks is often calculated by analyzing the dealer's experience. For example, the historical data might suggest a pattern such as 12% of the finance reserve is charged back within a year; 10% the second year, 4% the third year, 3% the fourth year, and 2% the fifth year. A reserve for uncollectible amounts could then be established based on this data and adjusted in future years for actual chargebacks. Exhibit 4 illustrates the accounting for chargebacks.

Exhibit 4
Illustration of Accounting for Chargebacks

The following illustration is simplified to demonstrate the concepts involved. Dealerships generally use more sophisticated methods, such as basing the calculation on months rather than years or using the interest method to estimate amounts at risk of chargebacks.

Facts. A dealership begins operation in 19X1. Its finance income is $500,000 in that year and $600,000 in 19X2. The dealership has a basis to estimate its chargebacks as follows: 12% will be charged back within a year, 10% the second year, 4% the third year, 3% the fourth year, and 2% in the fifth (this totals 31%). Actual chargebacks in 19X2 are $62,000.

Accounting in 19X1. At December 31, 19X1 the dealership shows a reserve or allowance for future chargebacks of $155,000 ($500,000 × 31%). It is established by the following entry:

Provision for chargebacks	155,000	
Reserve for chargebacks		155,000

The provision for chargebacks is a contra account to finance income. The reserve for chargebacks is generally shown as a current liability—often grouped with accrued liabilities—even though the reserve includes chargebacks for periods extending beyond the end of the following period.

The chargebacks absorbed in 19X2 of $62,000 exceed the allowance for that year ($500,000 × 12%) by $2,000. The chargebacks are recorded as follows:

Provision for chargebacks	2,000	
Reserve for chargebacks	60,000	
Cash		62,000

The entry shown is simplified. Actually the reduction in cash is realized through finance company settlements during the year.

The provision for chargebacks related to 19X2 finance income is recorded as follows ($600,000 × 31%):

Provision for chargebacks	186,000	
Reserve for chargebacks		186,000

At December 31, 19X2 the reserve for chargebacks is $281,000 which is expected to be charged back as follows:

	Expected to be charged back in				
	19X3	19X4	19X5	19X6	19X7
19X1 finance income	50,000	20,000	15,000	10,000	—
19X2 finance income	72,000	60,000	24,000	18,000	12,000
Total	122,000	80,000	39,000	28,000	12,000
Total reserve					281,000

8.320 Some dealerships' agreements with manufacturers' captive finance companies protect the dealership from possible future reductions in the finance reserve. In these cases the finance income paid to the dealership is lower than in the other types of arrangements but the finance companies absorb any defaults or early payoffs without charging back any amounts to the dealerships.

Leased Cars

8.321 In most cases, a leased vehicle is treated as a typical sales transaction because the dealership actually sells the vehicle to a leasing company that in turn leases the vehicle to the customer. However, in some situations, the dealership acts as lessor in which case the lease is generally treated as a sale under FASB Statement No. 13, *Accounting for Leases*. The receivable represents the total of the minimum lease payments (excluding any executory costs and profit on them to be paid by the dealer) and the value of the vehicle at the end of the lease (if the vehicle reverts back to the dealer at that time) discounted back to the date of sale using an appropriate interest rate (that is, the present value of the payments and value). The revenue to be derived from the lease is the total, undiscounted stream of payments. The difference is the income from the transaction, which is recognized over the life of the lease using the interest method (see section 8.306).

8.322 The disclosures that accompany sales-type leases are:

- Future minimum lease payments to be received and the amounts of executory costs (including any profit on them) and allowance for uncollectible lease payments
- Unguaranteed residual values that will revert to the dealer
- Unearned income
- Future minimum lease payments to be received in each of the next five years
- Total contingent rentals received for the period.

Other Accounts Receivable

8.323 Other accounts receivable arise from:

- amounts due on customer charge accounts for repair work and
- deposited checks returned from the bank.

Some dealerships include customer deposits as credits to accounts receivable; these should generally be reclassified to liabilities for financial reporting purposes.

Repossessions

8.324 In situations where the dealership has financed a sale and the customer's account becomes uncollectible, the dealership has the right to repossess the vehicle. The dealership should estimate the uncollectible losses and create a reserve. When a vehicle is repossessed and sold, any surplus over the amount owed needs to be returned to the customer. Some dealerships show the surplus as a credit to accounts receivable. It should ordinarily be reclassified as a liability for financial reporting.

8.325 Other potential uncollectibles include old receivables and old warranty and policy claims.

Transactions with the Manufacturer

8.326 **Holdbacks.** The term "holdback" refers to a method manufacturers use to bill the dealership an amount exceeding the actual dealer cost for each new car. The manufacturer holds this excess billing for a specified period of time and then returns it to the dealer. The dealership is not paid interest on the money nor does it have the prerogative not to participate. Holdbacks are common among domestic manufacturers, but are less common for imported cars.

8.327 The holdback generally represents 2 or 3% of the base price of the automobile (excluding options). It is recorded at the time the manufacturer invoices the dealership for the vehicle — generally when the vehicle is shipped. It may be paid to the dealer quarterly, semi-annually, or annually. Exhibit 2, transactions 1 and 6 illustrate accounting for the holdback.

8.328 **Other.** Other types of receivables common in auto dealerships are:

- Warranty claims receivable — the amount of warranty claims submitted for work performed less amounts received and claims disallowed.
- Predelivery service receivables — claims submitted to the manufacturer for predelivery work done on automobiles. Sometimes a dealer does predelivery work on a vehicle ultimately transferred to another dealer. In that case, the dealer that ultimately receives the vehicle pays the dealer that did the work and collects the claim amount from the manufacturer.
- Driver education allowance receivable — amounts from driver education vehicle allowances to be paid by the manufacturer.
- Vehicle incentives receivable — amounts due from manufacturers under various incentive plans.

- Other — such as insurance claims resulting from losses or damage to vehicles, tax claims due from taxing agencies, commissions receivable from the sale of insurance, and transportation damage claims.

8.400 INVENTORY

8.401 Inventory represents the largest single asset in most auto dealerships. Inventory can be divided into two major classes: Vehicles and other.

Vehicles

8.402 There are three major types of vehicle inventories: Demonstrators, new vehicles, and used vehicles.

8.403 Demonstrators. Demonstrator inventory comprises the value of new vehicles placed in demonstrator service. Generally these autos are taken out of the new inventory accounts. Any labor and materials cost for dealer-installed equipment and accessories is added to the inventory value; the cost of any such equipment or accessories removed from the vehicle is subtracted from inventory.

8.404 Many dealerships limit the number of miles that demonstrators may be driven (for example, 1,000 miles). Demonstrators are generally not written down for wear and tear or depreciation because, even after use, their market values generally exceed inventory cost. If cost exceeds value, however, a writedown may be necessary.[1]

8.405 When a demonstrator is sold, it is transferred back to new vehicle inventory as the sale is reported as a new-vehicle sale.

8.406 New Vehicles. New car inventories represent a substantial amount to a dealership. The cost of new vehicles represents the cost to the dealership. The items included in cost vary by manufacturer.

8.407 For example, General Motors establishes the cost of new vehicle inventory as:

Factory invoice amount

(plus) internal selling price of dealer add-ons

(minus) holdback

(minus) non-related items such as supplemental advertising

(minus) subsequent factory price reductions.

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[1] Dealerships that use LIFO, however, often find that no writedown is necessary because the LIFO cost (which is based on prior-year costs) is still less than value.

Care should be taken in this approach to insure that the cost represents the actual cost of the vehicle. If the internal selling price of dealer add-ons exceeds cost, the vehicle's carrying value should be reduced to reflect the actual cost of the add-ons. Subsequent factory price reductions should only be reflected in the cost if those reductions are applicable to the units in inventory.

Ford reduces the inventory carrying cost for factory rebates.

Toyota calculates inventory as:

Factory base price

(plus) factory installed options

(plus) freight

(plus) dealer association advertising charges.

8.408 Used Vehicles. Used vehicles are valued at the lower of cost or estimated *wholesale* value. Cost represents the actual cost of the vehicle when it is purchased. When the vehicle is acquired as a trade-in in conjunction with a new or used vehicle sale, the appraised value is used as cost. If a dealership expends funds for labor and materials to recondition a car, that cost is added to the appraised value to determine inventory cost. Other items that might increase cost are fees paid to outsiders, such as commissions and auction fees.

8.409 Used car carrying amounts are compared to appraised wholesale value monthly. Guides such as *Black Book* (which is published weekly) or NADA publications are used to assist in determining these values. The inventory carrying values are reduced to estimated wholesale value when they are lower than cost. This is done on a vehicle-by-vehicle basis, rather than for the used-car inventory as a whole.

8.410 When a vehicle is written down to appraised value, the accounting entry is:

Cost of sales — inventory adjustment	1,000	
Inventory — used cars		1,000

8.411 Special Uses. Auto dealers sometimes use new cars for purposes other than immediate sale. For example, vehicles might be used for driver education, demonstrators, or company use. When a vehicle is put to these purposes the accounting entries depend on the new use. Exhibit 5 illustrates the accounting for the special use:

Exhibit 5
Illustration of Accounting for Special-Purpose Vehicles

Vehicle transfer to the drivers education program:

1. The vehicle is transferred to another account.

Driver training vehicles	10,000	
Inventory — new cars		10,000

2. An allowance is received from the manufacturer to compensate the dealership for the wear and tear that accompany such a program.

Receivable from manufacturer	1,000	
Driver training vehicles		1,000

3. When the vehicle is no longer used in the program it is put into the used-car inventory. If the vehicle's appraised value exceeds its book value, the following entry is made:

Inventory — used cars	9,000	
Driver training vehicles		9,000

If the book value exceeds appraised value, the entry would be:

Inventory — used cars	8,000	
Expense	1,000	
Driver training vehicles		9,000

Use of a new car for general dealership purposes such as deliveries:

1. The vehicle is transferred to the company's use. (Because the dealership is converting the car to its own use, such transactions are subject to sales tax and title and license fees.)

Company vehicles	10,000	
Inventory — new cars		10,000

2. The vehicle is depreciated based on its estimated useful life. Depreciation expense is charged to operations annually, based on a four-year life.

Depreciation expense	2,500	
Accumulated depreciation		2,500

3. When the vehicle no longer is to be used for this purpose it is placed in used-car inventory. If the appraised value exceeds book value, the following entry is made:

Inventory — used cars	2,500	
Accumulated depreciation	7,500	
Company vehicles		10,000

If the appraised value is less than book, the entry is:

Inventory — used cars	2,000	
Accumulated depreciation	7,500	
Operating expense	500	
Company vehicles		10,000

The actual operating expense charged depends on the use the vehicle was put to.

8.412 Supplemental Advertising. Supplemental advertising represents a fee (for example, $150 per vehicle) to cover the cost of regional advertising that is added to the invoice price of each new vehicle. The fee, which the dealership voluntarily agrees to pay, is remitted by the manufacturer to the regional group of dealers, sometimes known as an advertising association. The supplemental advertising technically is an expense, but because the amount is included in the vehicle invoice it is often included in inventory cost. While such treatment is not in accordance with GAAP, it often is immaterial to the income and capitalization of the dealership.

8.413 Advertising associations came into existence as a result of criticism by auto dealers that manufacturers' national advertising does not address local needs and thus is not effective on a local basis. The manufacturers created these advertising associations, in order to cope with this criticism, shift advertising cost to dealers, and give them more say in local ad campaigns. Advertising associations either spend the entire proceeds received from the manufacturer or rebate a certain percentage of it back to the dealers to spend locally. Dealerships generally reflect the amount returned to them by the ad association either as other income or reimbursement of (or offset to) advertising expense.

8.414 Dealer Trades. Dealerships often trade vehicles with other dealers to satisfy customer demands. For example, a dealer whose customer wants a particular color or option package might not have such a car in stock but knows that another local dealer does. The dealer might then arrange to receive the car it needs by either purchasing it or swapping a similar car it has in stock.

8.415 A dealership that receives a car from another dealer records the transactions as follows:

New vehicle inventory	12,000	
Cash		12,000

8.416 After receiving the vehicle the dealer generally sells it and records a sale. If it keeps the vehicle it can arrange a floor plan loan.

8.417 A dealership that sends a vehicle to another dealer accounts for the transaction as a transfer rather than a sale. It must also pay off its floor plan note within the time allowed under its financing agreement. The accounting for the transaction is as follows:

Cash	12,000	
New vehicle inventory		12,000
Floor plan note payable	12,000	
Cash		12,000

8.418 Other. Other categories of inventory include:

- Parts and accessories: Purchased materials are recorded at current replacement cost. Most dealers take physical inventory of these items at least annually.
- Tires, gas, oil, and grease: These items are shown at cost. Physical inventories usually are taken annually for tires, monthly for others.
- Body shop materials: Body shop materials are carried at cost; physical inventories are generally taken monthly.
- Sublet repairs inventory: This represents repair work performed by others. The amount paid to others is capitalized into inventory. The account is reduced when the repair work is sold to customers.
- WIP-Labor: A separate inventory account accumulates compensation for technicians and others who perform productive labor. The amounts charged do not include absentee compensation, such as vacations, training, and holidays. The accumulation is generally checked in monthly physical inventories.
- Nonautomotive merchandise: This material is recorded at materials' cost plus any reconditioning costs.

8.419 Disclosures. Common inventory disclosures include:

- Major classes of inventory disclosed (ARB 43).
- Method of determining cost (for example, LIFO, FIFO) (ARB 43).
- Basis for stating inventory (for example, lower of cost or market) (ARB 43).
- Valuation allowances shown as deductions to inventory (APB 12).

8.420 The following is an example of the disclosure of significant accounting policies regarding inventory:

> New automobiles are stated at factory invoice cost less rebate and allowances plus dealer-installed options, determined by the specific unit method. Demonstrators are stated at the lower of this cost or market (as described under "used automobiles").
>
> Used automobiles are stated at the lower of cost or market.
>
> Parts, accessories, and supplies are stated at cost or at factory catalog prices, which approximate cost.

If the new and demonstrator vehicles and parts and accessories are under LIFO, the following would be the disclosure:

> New and demonstrator vehicles and parts and accessories are stated at cost, determined on the last-in, first-out (LIFO) basis, which is not in excess of market.

Statement of Cash Flows

8.421 Because auto dealers finance inventory purchases through the floor plan, rather than paying cash for them, questions occasionally arise about the treatment of inventory purchases in the statement of cash flows. A Technical Practice Aid issued by the staff of the AICPA Technical Information Services Division provides the following guidance:

> Inquiry: An automobile dealer purchases its inventory from a manufacturer which finances purchases through a finance subsidiary. The finance subsidiary pays the manufacturer directly on behalf of the dealer. Cash is not disbursed by the dealer until the automobiles are sold.
>
> Under the provisions of FASB Statement No. 95, *Statement of Cash Flows* (AC C25), how should the purchases of inventory be reported by the automobile dealer in the statement of cash flows?
>
> Reply: A statement of cash flows reports an enterprise's cash receipts and cash payments during the period. Transactions that do not involve cash receipts and cash payments should be excluded from the statement of cash flows. Noncash investing and financing transactions should be reported in separate disclosures.
>
> The purchases of inventory described above do not involve a cash flow by the automobile dealer until the automobiles are sold and the dealer pays the finance subsidiary under the financing arrangement. Therefore, only the cash outflows from payments to the finance subsidiary should be included in the body of the statement of cash flows.
>
> Payments made to the finance subsidiary of the manufacturer should be classified as operating cash outflows in accordance with FASB Statement No. 95, paragraph 23(a) (AC C25.121), which defines operating cash outflows to include principal payments on accounts and notes payable to suppliers for goods acquired for resale. (AICPA Technical Practice Aids, section 1300.16)

8.422 Thus, when the dealership finances its purchases through the manufacturer or a captive financing arm of the manufacturer operating cash flows include only the net change in the floor plan balance.

8.423 The Technical Practice Aid implies a distinction between financing provided by the manufacturer, which is the *supplier*, and that provided by a third party. It seems to suggest that repayment of loans for inventory financed by outsiders should be shown as financing outflows rather than operating outflows.

LIFO

8.424 Many companies use LIFO for one or more components of inventory. The method was particularly popular in the late 1970s and early 1980s, when inflation was high. Using the latest, and therefore highest, prices to calculate the cost of sales reduces taxable income and income taxes.

8.425 **Methods.** LIFO valuations are acceptable under GAAP and income tax law. GAAP does not specify how LIFO calculations are to be made. In fact, GAAP provides relatively little specific guidance as to LIFO. An exception is the November 30, 1984 issues paper, "Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories," prepared by the Task Force on LIFO Inventory Problems of the AICPA Accounting Standards Division. The issues paper presents discussion and advisory conclusions about certain matters concerning LIFO. However, keep in mind that issues papers are not considered established sources of GAAP (see section 8.010).

8.426 Many companies apply the methods dictated by the income tax regulations for financial reporting purposes. This approach is generally acceptable. Chapter 9 presents a detailed discussion of the method called for by Revenue Procedure 92-79.

8.427 The most common application of LIFO inventory valuation by auto dealers is for new vehicle inventories. Other components of inventory, such as parts, may also use LIFO, but often the time and effort necessary to apply this technique is not justified in view of the relatively small dollar amounts involved in low-inflation economic cycles.

8.428 Auto dealers generally use a dollar-value approach to LIFO inventory valuations. Under a dollar-value approach, inventory items are grouped by pools and are priced in terms of each pool's aggregate base-year cost. The result is compared with each pool's aggregate base-year cost as of the end of the prior year to determine whether the inventory level of each LIFO pool has increased or whether a portion of the inventory has been liquidated.

8.429 The most common technique employed by auto dealers is *link chain*. *Double extension* is also used.

8.430 Under link chain, the base cost of the ending inventory is determined by applying a *cumulative index* to the dollar value of the ending inventory. The cumulative index represents the total increase in prices since the base year. To arrive at the cumulative index, the current year prices are compared to those of the previous year to arrive at a multiple (for example, if this year's prices are 5% higher than last year's the multiple would by 1.05). This factor, or index, is then applied to the previous year's cumulative index resulting in a new cumulative index. Thus, the term link-chain implies that each year's index is a link in a chain of indexes back to the base year.

8.431 The double extension technique involves multiplying current and base year costs of each item in the inventory by the units on hand at the current year reporting date. Typically the results under the two approaches are very similar when the items in a pool are constant. However, this is generally not the case for a new car dealership and as such the link-chain method is preferred.

8.432 **Applying LIFO.** Many dealerships use the approach specified by IRS Revenue Procedure 92-79 for new car inventories, which is based on a link-chain approach. The advantages to using the IRS approach are its simplicity, its acceptance by the IRS, and the protection it affords for LIFO computations done for the years preceding the year of its adoption.[2]

8.433 Revenue Procedure 92-79 requires a 14-step approach to calculating LIFO values for new-car inventories, which is discussed in detail in Chapter 9. However, in essence the procedure calls for:

- Calculation of an index based on the current- and prior-year *average base cost* for each *model*,
- Calculation of a single cumulative index for the new car inventory,

[2] Adoption of IRS Revenue Procedure 92-79 requires recomputation of prior-year indexes. See Chapter 9.

- Application of the index to the *entire* inventory value, *including* options and supplemental advertising. "Advertising Fees" have been declared by IRS in a private letter ruling to be non-inventory costs, currently deductible for income tax purposes (subject to IRS economic performance rules).

8.434 IRS Conformity Rules. The IRS requires taxpayers using LIFO for tax purposes to use LIFO for financial reporting purposes also. This means that the primary financial statements must also use LIFO. The same LIFO *technique* need not be used for both purposes, although use of different techniques for book and tax purposes is exceedingly rare. (Note: The IRS Conformity Rules do not apply to other than annual statements of operations.)

8.435 Companies that report their inventories on a LIFO basis may want to, or be required to, present information on results of operations using a different method, such as FIFO. In those cases, the primary financial statements should use LIFO and this other information should be presented in financial statement notes or in supplementary schedules. However, this additional information should not be presented in a way to suggest that the non-LIFO approach is better or more realistic than the approach incorporated in the financial statements. IRS has prescribed rules regarding non-LIFO disclosures in footnotes or supplemental schedules that must be followed to avoid income tax conformity violations.

8.436 Interim Periods. Tax law defines LIFO in terms of annual reporting and annual calculations. Accordingly, applying LIFO to interim financial statements often raises questions.

8.437 To estimate the cost of sales for an interim period, companies use either of the following approaches:

- Calculating the effect on LIFO for each interim period based on the year-to-date data. Some estimate this based on price changes, others also take into account inventory level changes.
- Projecting the expected annual LIFO cost and allocating that projection to the interim periods equally or in relation to certain operating criteria such as number of vehicles purchased. This estimate might be updated periodically.

8.438 When inventory levels drop, LIFO assumes some of the base inventory has been sold. LIFO reflects this through liquidation of a previous year's inventory layer. When the drop occurs in an interim period there is the possibility that levels will rise again before the end-of-year inventory determination. In that case, APB Opinion No. 28 requires that the interim earnings not reflect the LIFO liquidation.

8.439 The AICPA issues paper suggests two alternatives for handling the resulting credit to inventory:

- Record the pretax income effect of the LIFO inventory liquidation as a deferred credit in the current liabilities section of the balance sheet and reflect the liquidation in inventory (that is, debit inventory for the amount of the LIFO reserve that would be eliminated under the interim calculation and establish a deferred credit for the amount under current liabilities), or
- Do nothing; allow the reserve to remain intact until year end.

8.440 Special Disclosures Under LIFO. The following matters are generally disclosed when LIFO inventories are presented in the financial statements.

- The use of LIFO, although the specific technique employed (for example, link chain) need not be disclosed.
- The amount of the LIFO reserve or the replacement cost of inventories reported at LIFO.
- The amount of inventory valued under each method, when only a portion of inventory is valued under LIFO.
- The effects on income of any LIFO liquidations.

8.441 The following illustrates a disclosure that would be made when LIFO is used (the second sentence is appropriate only when there has been a LIFO liquidation):

> Inventories reported on the LIFO basis represented X% of total inventory and were approximately $X less than the current cost. As a result of reducing certain inventory quantities reported at LIFO, profits from liquidations of inventories were recognized increasing net income by $X.

8.500 DEBT AND OTHER LIABILITIES

Floor Plan

8.501 The *floor plan* is the liability for the wholesale price of new, and sometimes used, vehicles. Auto dealerships generally establish agreements under which a financing institution provides short-term financing for the dealers' acquisition of vehicles. The financing institution can be related to the manufacturer, such as GMAC or Ford Motor Credit, or it can be separate, such as a bank. The dealer typically executes a separate note to the financing institution for each vehicle purchased under this arrangement, pledging the vehicle as collateral.

8.502 Interest on notes payable executed under a floor plan is generally paid monthly. Any unpaid interest is generally shown as a current liability in the dealership's financial statements.

8.503 Floor plan arrangements generally don't require payment of the note until the dealership sells the auto that underlies the note. The note and accrued interest must be settled, however, within a short time of the sale, generally 72 hours. If a note is not paid off within the prescribed time, the dealer is said to be *out of trust*. That is, it is still in debt but has disposed of the collateral.

8.504 Being out of trust is ordinarily an event of default under the notes still outstanding. Accordingly, a financing institution has the right to call all the other notes outstanding from a dealership in default, unless the dealership can correct the out-of-trust condition immediately according to the provisions of the floor plan agreement.

8.505 Generally, floor plan notes are current liabilities because they relate to cars held for sale. Sometimes, however, the notes are for vehicles the dealership leases out under operating or sales-type leases. When the leases are for periods more than one year, the related floor plan note is shown as a long-term liability.

8.506 The following illustrates a common disclosure of floor plan notes and the inventory used as collateral for them:

Arrangements with Financial Institutions

The amounts payable to financial institutions under trust receipt transactions and the inventory amounts of vehicles financed under them as of December 31, 19XX are:

	Carrying Amount of Inventory			Obligations
		Not		to Financial
	Total	Financed	Financed	Institutions
New vehicles	$XXXX	$XXXX	$XXXX	$XXXX
Used vehicles	XXXX	XXXX	XXXX	XXXX
Demonstrators	XXXX	XXXX	XXXX	XXXX
Total	$XXXX	$XXXX	$XXXX	
Obligations on financed vehicles sold before December 31, 19XX, for which remittance had not been made to financial institutions (Remittance was made on all these obligations by January 4, 19XY)				XXXX
Total				$XXXX

Customer Deposits

8.507 Customer deposits is a liability account representing cash received on account for sales subject to future delivery. Many dealers, however, credit these receipts to customer accounts receivable instead (see section 8.323). In either case the amounts should be presented as current liabilities for financial reporting.

Accounts Payable — Other

8.508 Among the more significant other payables are:

- Amounts due on vehicle liens. A dealership acquiring a trade-in encumbered by a customer's outstanding note must pay the note. It's important for the customer's credit rating and the dealership's ability to get clear title to the vehicle that these liens be paid off quickly. Accordingly, at the balance-sheet date this amount should represent only the last few days' trade-ins.

- Deposits collected from customers not yet paid to appropriate recipients. Items such as sales or gross receipts and luxury taxes as well as tag and titling fees are collected from customers for remittance to government agencies. Before these amounts are paid they are shown as accounts payable. Title and tag charges usually do not accumulate for more than a week or two before being remitted.

- Reserve for repossession losses. Dealerships generally makes monthly provisions for estimated repossession losses on both new and used vehicles. (See section 8.324.)
- Reserve for service contract losses. Auto dealers estimate service contract losses on both new and used vehicle service contracts sold and underwritten by the dealership. (See section 8.619.)
- Reserve for chargebacks of finance income. (See section 8.319.)

Disclosures

8.509 Common disclosures related to payables include:

- Disclosure of interest rates, maturities, and other terms
- Combined aggregate amount of maturities for each of the next five years (FASB Statement No. 47)
- Imputed interest (APB Opinion No. 21)

8.600 REVENUE

Vehicle Sales

8.601 Vehicles are considered sold when the customer takes delivery. Vehicle sales generally present no unusual revenue recognition problems, since there is generally no right to return the vehicle (FASB Statement No. 48) and there are no exceptional doubts about collection of the sales price that would require use of the installment method or cost recovery method of revenue recognition (APB Opinion No. 10).

8.602 The vehicle's sales price is the consideration received by the auto dealer from the customer. This is generally, but not always, the contract price (excluding taxes, title, and tags).

8.603 When the sales contract includes a trade-in allowance, the value of the trade-in must be considered. The trade-in should be recorded at the fair market value of the vehicle. Dealers sometimes negotiate trade-in allowances in excess of the fair market value of the vehicle traded in. In that case, the revenue from the sale must be reduced to reflect the lower value of the trade-in. Exhibit 2, transaction 4a illustrates this adjustment.

8.604 When the sales agreement includes dealer financing, the interest rate used in the financing must be reasonable. If not, a reasonable rate should be imputed to the note and the value of the note, and thus, the revenue from the sale, should be adjusted. Section 8.305 discusses this in more detail.

Buy Here, Pay Here Operations

8.605 Some dealers operate low-end used-car lots called *buy here, pay here* lots. These operations entail the sale of less expensive cars and, generally, dealership financing. Customers typically provide a down-payment and finance the balance by a note to the dealership.

8.606 These operations often involve high margins as well as high customer default rates and lack of effective collateralization. Accordingly, collectibility is often in doubt. APB Opinion No. 10 says that when "there are exceptional cases where receivables are collectible over an extended period of time and . . . there is no reasonable basis for estimating the degree of collectibility . . . either the installment method or the cost recovery method of accounting may be used."

8.607 The installment method defers the gross profit and treats each payment as if it included both recovery of cost and gross profit in the same ratio as the original sale. Thus, if the original sale presumed a 60% gross profit, each principal payment would reduce the deferred gross profit by 60% of the amount received. Any receivables due more than one year from the balance-sheet date should generally be classified as noncurrent.

8.608 Under the cost recovery method revenue is credited and cost of sales debited for all receipts until costs are fully recovered. Only after receipts exceed the carrying value of the vehicle sold does the dealership recognize any profit.

8.609 The notes generally carry stated interest rates in excess of current market rates, often as high as 30%. The reasonableness of the interest rate in the circumstances should be considered. See section 8.305 for a discussion of imputed interest when these rates are unreasonable in the circumstances.

Leases

8.610 Dealerships sometimes lease vehicles rather than sell them. In most cases, the dealership does not maintain the lease, but transfers it to a financing institution such as Ford Motor Credit Company or General Electric Capital Auto Lease. Because the floor plan notes generally become due when the collateral is no longer in the dealership's possession, by transferring the lease the dealership receives its money at the inception of the lease and can pay off its note.

8.611 In these cases the dealership merely records the transfer as a vehicle sale. That is, the dealership records a sale to the financing institution and the financing institution obtains a vehicle subject to a lease and the responsibility to account for the lease transaction. The price used to record the sale is calculated based on the actual cost of the vehicle, the lease term, the customer's lease payments, and the vehicle's expected value at the end of the lease. How these factors are weighed in the actual sales price calculation varies by financing institution.

8.612 Sometimes dealerships retain vehicle leases rather than transferring them. When a long-term lease meets the criteria established by FASB Statement No. 13, *Accounting for Leases,* the lease is treated as a sale.

8.613 To be treated as a sales-type lease the following conditions must be met:

First, at least *one* of the following four conditions must exist:[3]

[3] The third and fourth conditions do not apply if the lease is entered into during the last 25% of the vehicle's estimated economic life.

1. The lease transfers ownership of the vehicle to the customer by the end of the lease term,
2. The lease contains a bargain purchase option,
3. The lease term is equal to at lease 75% of the vehicle's estimated economic life, or
4. At the beginning of the lease term, the present value of the minimum lease payments (excluding executory costs) is at least 90% of the fair value of the vehicle.

Second, the lease must fulfill *both* of the following criteria:

1. Collectibility of the minimum lease payment is reasonably predictable, and
2. No important uncertainties, such as guarantees against obsolescence, surround the amount of unreimbursable costs yet to be incurred by the auto dealer.

If the lease meets these criteria, it is treated as a sale by the auto dealer.

8.614 Many leases establish a mileage charge in addition to the minimum lease payments. For example, the lease might call for a charge of 15¢ for each mile over 15,000 annually. These are not considered in the minimum lease payments; they are considered *contingent payments* under FASB Statement No. 13. Accordingly, they do not enter into the calculation of the sales price of a sales-type lease. Instead, they are recognized when they are determined to be receivable. FASB Statement No. 13 requires that the total contingent rentals included in income should be disclosed in the financial statements.

8.615 Dealerships often enter into operating-type leases as well. Some of these are long-term leases that do not meet the criteria established in FASB Statement No. 13 for sales-type leases. Others are short-term rentals done for the benefit of customers whose vehicles need repair.[4] In these cases rental revenue is recognized as its earned. Many floor plan arrangements allow the dealer to pay off a portion of the debt (say 2%) every month for these vehicles. The percentage used to pay off the floor plan is often used also as a basis for determining depreciation. Vehicles under long-term leases should generally be included under property and equipment in the financial statements. Vehicles used for short-term rentals are generally in service for less than a year and are usually shown as inventory. Exhibit 5 on pages 8-18 and 8-19 illustrates how dealerships record vehicles returned to used-car inventory when they are no longer used for special purposes.

8.616 For operating leases, the auto dealership needs to disclose the following in its financial statements:

- Cost and carrying amount of property on lease or held for leasing by major classes and the amount of accumulated depreciation as the date of the balance sheet.
- The aggregate minimum future rentals on noncancelable leases as of the balance-sheet date and for each of the five succeeding years.

[4] The same accounting is generally used for loaners except that there is no rental revenue. Many dealerships include loaners under inventory in their financial statements.

- Total contingent rentals included in income for the year.
- A general description of the leasing arrangements.

Maintenance Contracts

8.617 Almost one out of three new vehicle purchasers buys an extended service contract. These contracts are profitable, accounting for 5% of vehicle sales gross profit in 1991 according to NADA. They might be underwritten by the manufacturer, an unrelated insurance company, or the dealership itself.

8.618 When the contract is underwritten by the manufacturer or an unrelated insurer, the dealership has no ongoing responsibility for the contract. It recognizes the amount it charges the customer less the amount it remits to the underwriting party as income at the time of the contract. Repair services provided under such a contract are billed to the underwriting party at rates that vary based on the contract. Generally, contracts sold by the manufacturer call for the dealership to be paid the same rates used for factory warranty work. Third parties are generally charged full retail rates but occasionally the contracts limit the rates charged.

8.619 When the dealer underwrites the contract itself the accounting is specified by FASB Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts.* The Technical Bulletin indicates that the revenue from such a contract should be deferred and recognized on a straight-line basis over the life of the contract, unless the costs of performing the services are expected to be incurred on some other basis. Any costs directly attributable to acquiring the contract (such as a commission or other direct acquisition costs) should also be deferred and should be charged to income using the same method used for the revenue.

8.620 If the dealership expects the costs of providing services (and any unamortized costs) under a group of contracts to exceed the unearned revenue, a loss should be recognized. The loss is to be recognized by charging an expense account. Any unamortized costs should be credited and, if the loss exceeds the unamortized costs, and a liability should be established for the excess.

Parts and Repairs

8.621 Mechanical and body repairs are sold to customers, done under warranty provisions, and provided for other dealership departments (for example, reconditioning used cars and repairing company cars). The service and parts department represents one of the most profitable areas of an auto dealership — in 1991 the average dealer reported a 43% gross profit on service and parts sales (according to NADA).

8.622 Revenue from repairs done for customers or parts sold to customers is recognized at the time of sale. The timing of revenue recognition is not generally controversial since parts sales are typically retail transactions, often done on a cash basis.

8.623 Although most repairs are completed the day they are begun, there are generally a handful of vehicles to be under repair overnight. The dealership should account for repairs uncompleted at the balance-sheet date using the completed-contract method. That is, the cost of materials and labor should be capitalized into inventory (work in process), any deposits reported as a liability, and no income recognized until the repair is complete and the customer is billed.

8.624 When parts or repairs are provided for other dealership departments, the costs passed on to those other departments generally include a mark-up over the direct labor or materials cost. The mark-up generally represents an allocation of overhead. Under some dealerships' accounting systems the transferring department records a sale and the receiving department a purchase. Interdepartmental charges should be eliminated for financial reporting, but often they're not. In the latter case the mark-up can overstate both sales and expenses although there should be no effect on net income. Consideration should be given to adjusting the financial statements to eliminate the overstatement if the mark-up is material.

8.625 In no case should the mark-up include any departmental profit. If it does, that profit, if material, should be eliminated from the carrying value of any vehicles on hand at the balance-sheet date. Otherwise both assets and income will be overstated.

Finance Income

8.626 When the dealership provides the customer with financing and the note is sold to a financial institution, that institution generally pays the dealership a fee. The fee varies based on the relative risk assumed by the financial institution and the dealership (see section 8.317). The fee is recognized in income when the note is transferred to the financial institution. If a customer prepays or defaults on the note, disrupting the expected cash flow, the financial institution reduces (charges back) a portion of the fee to the dealership. Accordingly, the dealership should establish a reserve for an estimate of the finance income that will ultimately be charged back (see section 8.318).

Commission Income

8.627 Sales of insurance contracts are a source of income to auto dealers. Total finance and insurance income (called F&I in the industry) averaged about 13% of vehicles sales gross profit industry-wide in 1991, according to NADA.

8.628 Types of insurance sold include warranties (discussed in section 8.617), property and casualty insurance, and credit life insurance. Generally the dealership collects a gross premium, keeps a commission and remits the balance to the insurance company. When insurance contracts are canceled, the dealership is generally charged back a portion of the commission income, although most charge-backs tend to occur in the first year. Accordingly, it may be necessary to establish a reserve for future chargebacks.

8.700 EXPENSES

Cost of Goods Sold

8.701 The cost of product is a dealership's largest expense. Cost of vehicles sold is generally determined on a specific-identification basis. The specific vehicle sold is identified and the cost determined based on:

- that vehicle's manufacturer's invoice price and dealer-installed options, for new cars,
- the cost or, when lower, appraised value, for used cars.

When LIFO is used, the cost of sales is adjusted to recognize the LIFO value for the ending inventory (see section 8.424).

8.702 Cost of other materials, such as parts and supplies (grease and oil, for example) is determined through periodic inventories (see section 8.418). The costs generally represent purchase costs. However, interdepartmental transfers of materials are usually marked up to an *internal selling price,* which often includes an allocation of overhead.

Repossession Losses

8.703 Repossession losses arise from customers' failure to pay notes taken to finance their vehicle purchases. If a dealership finances the purchase, its loss represents the amount of the note that is uncollectible less any recovery from sale of the repossessed vehicle. (Dealer-financed sales are discussed in sections 8.605–8.609.) When a finance company provides the financing, the dealer might still recognize a loss if it retains some of the nonpayment risk (see section 8.310).

8.704 A common approach is to establish a reserve based on outstanding notes. For example, the dealership might total all outstanding customer notes in which it has a financial interest and calculate a reserve based on its estimate of doubtful notes (often based on a percentage, say 3%). This amount would be charged to expense and shown as a liability. Any write-offs would be charged to the liability.

8.705 Even if the dealership does not retain some of that risk, it risks the loss of a portion of the finance income it recognized on the transaction (see section 8.317).

Income Taxes

8.706 Auto dealerships that prepare financial statements in accordance with GAAP must follow the provisions of SFAS No. 109, *Accounting for Income Taxes*. SFAS No. 109 requires recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities, using the enacted tax rates in effect for the year in which the differences are expected to reverse.

8.707 Many auto dealerships are structured as Limited Liability Companies, "S" Corporations, and partnerships and therefore do not provide for income taxes in their financial statements. Further, such entities generally disclose the reason for the lack of a tax provision. The following is a disclosure an "S" Corporation might use for this purpose:

> The Company and its stockholders have elected for tax purposes to be treated as a "Small Business Corporation" under Subchapter "S" of the Internal Revenue Code. In accordance with the provisions of such election, the Company's income passes through to its stockholders; accordingly, no provision for income taxes has been made.

8.708 Auto dealerships that are subject to income taxes and prepare financial statements in accordance with GAAP are subject to a number of specific disclosure requirements (see the Financial Statement Disclosure Checklist in Chapter 11, section 11.400). The following is an example of the disclosures required:

NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income Taxes

Deferred tax liabilities and assets are recognized for the tax effects of differences between the financial statement and tax bases of assets and liabilities. A valuation allowances is established to reduce deferred tax assets if it is more likely than not that a deferred tax asset will not be realized.

NOTE X: INCOME TAXES

Deferred income taxes (benefits) are provided for certain income and expenses which are recognized in different periods for tax and financial reporting purposes. Sources of temporary differences and the resulting tax assets and liabilities are as follows:

	January 1, 19X4 Deferred Tax Assets	Current Year Changes	December 31, 19X4 Deferred Tax Assets
Allowance for doubtful accounts	$ 20,294	$ (6,961)	$ 13,333
Inventory overhead costs capitalized for tax purposes	2,153	1,394	3,547
Accrued compensated absences	11,309	8,287	19,596
Allowance for inventory pricing adjustments	6,371	8,716	15,088
Depreciation	27,734	20,444	48,177
Net operating loss carryforward	211,719	(26,611)	185,108
	279,580	5,269	284,849
Valuation allowance	(279,580)	(5,269)	(284,849)
	0	0	0
Applicable tax rate	39%	39%	39%
Amounts per balance sheet	$ 0	$ 0	$ 0

The provision for income taxes consists of the following:

Current	$ 0
Deferred	0
Total income tax expense	$ 0

The following is a summary of carryovers available at December 31, 19X4:

Year of Expiration	Net Operating Loss Carryovers
2006	$ 137,630
2007	360
2008	47,118
	$ 185,108

A reconciliation of income tax expense at the statutory rate to the Company's actual income tax provision is shown below:

Computed at the statutory rate (34%)	$ (5,791)
Increase (decrease) in taxes resulting from:	
Nondeductible life insurance costs	3,947
Nondeductible travel costs	52
State income taxes and other	(256)
Change in deferred tax asset valuation allowance	2,048
Actual tax provision	$ 0

8.800 OTHER MATTERS

Related Party Transactions

8.801 Often, auto dealerships engage in transactions with affiliates of the dealership's owners or officers. These transactions might involve real estate leasing (for example, the dealership building might be owned by the dealership owner), vehicle transactions (for example, the dealership owner might also own a leasing or used car company that buys cars from the dealership or other dealerships), insurance, or allocation of common administrative costs.

8.802 FASB Statement No. 57, *Related Party Disclosures,* requires the following matters to be disclosed:

- The nature of the relationship involved
- A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed and any such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
- The dollar amounts of transactions for the period and the effect of any change in the method of establishing the terms from that used in the previous period
- Amounts due from or to related parties as of the balance-sheet date and, if not otherwise apparent, the terms and manner of settlement.

Environmental Matters

8.803 Because dealerships generally must store and dispose of gas, oil, and batteries, environmental issues can be significant. If the dealership has been designated by the Environmental Protection Agency as a potentially responsible party (called a "PRP"), it may incur significant costs to clean up hazardous wastes. Even if it has not been designated as a PRP, the dealership may need to consider contingent liabilities for cleanup costs.

8.804 A liability should be established if a loss relating to a cleanup is probable and can be reasonably estimated. Although the best estimate of the liability should be used, the accrual should not be delayed while the client attempts to accumulate information to arrive at a single amount as a best estimate if the loss can be estimated within a range. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, indicates that the best estimate within the range should be accrued. If no amount within the range is better than any other amount, the *minimum* amount of the range should be accrued. In addition, the additional exposure to loss should be disclosed if there is a reasonable possibility of loss in excess of the amount accrued.

8.805 The FASB Emerging Issues Task Force determined, in issue 93-5, *Accounting for Environmental Liabilities*, that the liability should be considered separately from any potential recovery from other potentially responsible parties. The loss arising from the recognition of the environmental liability should be reduced only when a claim for recovery is *probable* of realization. The balance sheet liability should not be offset by a recovery receivable unless the right of offset exists under FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

8.806 The following examples illustrate financial statement disclosure of environmental issues:

> *Example 1*: In February 19X1 the Company was notified by the U.S. Environmental Protection Agency that it had been named as a potentially responsible party in connection with the cleanup of hazardous wastes at its former used-car lot on Edgewood Avenue. Since the matter is in its preliminary stages, no assurance can be given at this time concerning the ultimate outcome of this matter. However, based on preliminary investigations to determine the Company's potential liability and the estimated amount of remedial costs necessary to clean up the site, the Company presently does not expect this matter to have a material adverse effect on its financial condition.
>
> *Example 2*: Federal, state, and local laws and regulations govern the Company's operation of underground fuel storage tanks. Rather than incur additional costs to restore and upgrade tanks as required by regulations, management has opted to remove the existing tanks. The Company is in the process of removing these tanks and has identified certain tanks with leaks that will require remedial cleanups. The Company accrued approximately $675,000 as an operating expense in 19X1 for the estimated future costs of these clean-up efforts. As of December 31, 19X1, approximately $250,000 of these costs had been incurred. The remaining in-ground tanks are being monitored for leakage and the Company does not expect any additional material expenses in future years associated with fuel storage tanks.

Risks and Uncertainties

8.807 AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires disclosures in four general areas:

- Nature of operations
- Use of estimates
- Certain significant estimates
- Vulnerability due to concentrations.

The SOP is effective for periods ending after December 15, 1995. When comparative financial statements are presented, the disclosures are required only for the later period.

8.808 Nature of Operations. The SOP requires a description of the company's major products and the principal locations of its market. The following is an example of such a disclosure for an auto dealership:

> The company's principal business is the retail and fleet sales of new automobiles and trucks. It also retails and wholesales replacement parts and used automobiles and provides vehicle servicing. The company operates mainly in the South Florida area.

8.809 Use of Estimates. The SOP's requirement to disclose the use of estimates is a boilerplate type of disclosure. Accordingly, it is generally the same for auto dealers as for other types of entities. The disclosure illustrated in the SOP reads as follows:

> The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

8.810 Certain Significant Estimates. The SOP requires certain disclosures when it is reasonably possible that, due to the occurrence of confirming events, a significant estimate will change within one year of the balance-sheet date and the change will be material. Chargebacks of finance and insurance income and environmental remediation matters might be considered significant estimates that require disclosure in an auto dealership's financial statements. An example of a disclosure regarding finance income is:

> The company earns income from originating customer car loans and assigning the loans to financial institutions at discounted amounts. The financial institutions charge the unearned portion of the discount back to the company in the event that the customer does not make all the payments due to default or early repayment. An allowance has been established for future finance chargebacks based on the company's historical experience.

8.811 Vulnerability Due to Concentrations. Auto dealers generally have the following types of concentrations that need to be disclosed:

- Supplier concentration — most car dealers have exclusive agreements with single manufacturers
- Geographic concentration — most car dealers operate in single geographic areas
- Labor-force concentration — if employees are unionized the supply of labor is considered to be concentrated.

8.812 An example of a disclosure of supplier concentration is as follows:

> The company purchases substantially all of its new vehicles and parts from Ford Motor Company, Inc. at the prevailing prices charged by the automobile distributor to all franchised dealers.

Accounting and Reporting by Limited Liability Companies

8.813 The AICPA Accounting Standards Executive Committee's Practice Bulletin No. 14, *Accounting and Reporting by Limited Liability Companies* (April 1995), establishes guidance for limited liability corporations and limited liability partnerships. The guidance is effective for financial statements *issued* (not *dated*) after May 31, 1995.

8.814 Titles. The practice bulletin requires that the financial statements' headings make clear that the auto dealership is a limited liability company. This is generally communicated by the initials LLC or LLP in the entity's name. However, if the local law does not require the entity to include such a designation in its name, the financial statement headings should refer to the company's limited liability. For example, the balance sheet's heading might read:

ABC Auto Dealership
(A limited liability corporation)
Balance Sheet
As of December 31, 19XX

8.815 Creation of the Entity. A limited liability company might be formed from existing entities, either by converting an existing entity or by the combination of two other entities. When the limited liability company is converted from another type of entity, the dealership should report its assets and liabilities at the amounts shown by its predecessor. If the company is formed by the combination of two or more entities under common control, the combination should be reported similar to a pooling of interests. In either case, the financial statements should disclose that the assets and liabilities previously were held by a predecessor entity or entities.

8.816 Most limited liability companies are exempt from income taxes. If the predecessor entity was a taxable entity whose financial statements included deferred tax assets or liabilities, the deferred amounts should be eliminated as of the date the entity becomes tax exempt.

8.817 The presentation of comparative financial statements is generally encouraged under GAAP. However, if the entity has changed corporate form, the prior year's financial statements might not be comparable. If, in that case, multiple years' financial statements are presented, the exceptions to comparability should be disclosed in the financial statements.

8.818 Equity. The equity section of the balance sheet of a limited liability company should resemble that of a partnership. Since owners of limited liability companies are called "members," the equity section should be called "members' equity." If there are different classes of members' interests, that is, classes with different rights, preferences or privileges, the financial statements should describe each class. The amounts attributable to each class should be disclosed either in the equity section or in the financial statement notes.

8.819 Amounts due from members for capital contributions should be shown as deductions from equity. These amounts should not be shown as assets unless there is substantial evidence of ability and intent to pay within a reasonably short period of time.

8.820 Other Disclosures. The financial statements should also disclose:

- Any limitation of the members' liability
- The date the company will cease to exist, if the company has a finite life.

Taxation

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TAXATION

9.000 INTRODUCTION

9.001 Auto dealerships are subject to a broad range of tax issues at the federal, state and local levels of government that impact all aspects of their operations. This Chapter discusses key federal income tax issues and certain other excise taxes and reporting requirements pertinent to auto dealerships. Selected state taxation issues having applicability in general to all auto dealerships are also discussed. (A detailed discussion of specific state and local taxation issues is beyond the scope of this Chapter.)

9.100 CHOICE OF ENTITY

Business Considerations

9.101 The decision regarding choice of business form requires a balancing of both tax and nontax considerations peculiar to the business and the principals involved. Although a dealership can choose any business form, a sole proprietorship (assuming the auto manufacturer would permit this business form) and a general partnership (except for a partnership of corporations) fail to limit the liability of the principals to their investment in the dealership and typically are inappropriate choices of entity for that reason. The following is a partial list of the nontax considerations for the dealership's choice of entity.

9.102 Separate Legal Entity. A business organization that is considered a separate legal entity possesses the right to sue or be sued, enter into contracts, and hold, deal in, and dispose of property in the company's name. A corporation[1] and a limited liability company (LLC) are separate legal entities. Not all states, however, recognize limited liability companies. Consequently, an LLC doing business in another state risks not being recognized as a separate legal entity if that state that does not recognize LLC status. Although common law did not treat partnerships as separate legal entities, most states have enacted statutes that enable partnerships to act in their own name.[2]

9.103 Management Reporting and Control. Corporations have centralized management and control that rests with its board of directors.[3] Although the corporation's shareholders elect the directors, once elected they are only indirectly responsive to shareholder control. Except for specific actions, corporate decisions generally do not involve the shareholders. The operation of a corporation is a formal process

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[1] Model Business Corporation Act Section 4 (1979).

[2] Uniform Partnership Act Section 10.

[3] Model Business Corporation Act Section 35.

requiring that corporate actions be in accordance with the by-laws and articles of incorporation, periodic meetings of directors and shareholders be held, additional tax forms be filed, and the corporation register in states where it intends to do business. Limited partnerships possess a form of centralized management similar to corporations. Management of the limited partnership is vested in the general partners and there must be at least one general partner.[4] The limited partners are analogous to corporate shareholders. An LLC may be operated by its members or by managers appointed by the members.

9.104 Continuity of Life. Corporations have a perpetual existence unless a limited period of existence is specified in the articles of incorporation.[5] The business is not interrupted by the death or withdrawal of individual shareholders. As a practical matter, however, the shares of a closely held corporation often have no ready market and the death or withdrawal of a shareholder is of more consequence to a closely held corporation than in a large publicly held corporation. In a closely held corporation, buy-sell agreements are advisable for the protection of both the corporation and the individual shareholders. Redemptions or stock purchase plans can be funded by life insurance on the life of each shareholder and/or through a structured buyout program agreed to in advance by the shareholders.

9.105 The death or withdrawal of a partner may result in the dissolution of the partnership. However, the partnership agreement can provide for the remaining partners' buyout of the withdrawing partner. The partnership agreement must contain effective provisions to assure continuation of the business, otherwise liquidation could result in substantial losses to all partners. Continuity of existence for limited partnerships may be achieved by the partnership agreement limiting the withdrawal of the limited partners' capital contributions and by stating the term of the partnership's existence.[6]

9.106 The existence of an LLC may be restricted to a fixed term either by state statute or by the articles of organization to avoid having sufficient corporate characteristics that would result in taxation as a corporation.[7]

9.107 Transferability of Interests. Corporate shareholders, absent restrictions, are free to transfer their shares without prior consent. Partners in a partnership and general partners in a limited partnership, absent an agreement to the contrary, must obtain the consent of all partners to transfer their interests. Limited partners in a limited partnership are free to assign their partnership interests, subject to restrictions provided in the partnership agreement. However, depending upon the provisions of the partnership agreement, the assignee may have only the assignor's right to share in profits and not be a substitute limited partner unless the other partners consent.[8] Members of an LLC are free to transfer their membership interests absent restrictions in the articles of organization.[9]

9.108 Formality of Organization. The corporate business form requires specific incorporation formalities and expenses, the payment of annual franchise taxes, and annual registration in the states in

[4] Revised Uniform Limited Partnership Act Section 403.

[5] Model Business Corporation Act Section 4(a).

[6] Uniform Partnership Act Sections 30 and 31.

[7] Internal Revenue Code (IRC) Regulations Section 301.7701-2.

[8] Uniform Limited Partnership Act Section 19 and Revised Uniform Limited Partnership Act Sections 702 and 704.

[9] See, for example, Florida Statute Section 608.432.

which it intends to conduct business. Moreover, the corporation must obtain authority from the state to conduct business and maintain a registered agent in that state. General partnerships can be organized with a minimum of expense and formality. Partnership agreements, although strongly recommended, are not a prerequisite to conducting business. Limited partnerships must comply with statutory formalities, including the filing of a certificate of limited partnership and a written limited partnership agreement.[10] An LLC is required to have articles of organization and conform to the statutes of the state in which it is organized.[11]

9.109 Sources of Capital. Corporations have the flexibility to obtain either debt or equity capital. Debt capital is obtained through loans with specific repayment terms. Equity capital, such as common or preferred stock, gives the investor an ownership in the business without obligation to fixed repayment terms. A partnership's capital sources are limited to contributions of capital from existing partners, loans from the partners or loans from third party creditors. An LLC has the same options for raising debt and equity capital as a corporation.

9.110 Foreign Investor Considerations. Favorable income and estate tax treatment is afforded foreign investors under certain Internal Revenue Code provisions.

- Interest income on portfolio investment debts to nonresident alien (NRA) individuals who are less than 10 percent shareholders in an auto dealership is exempt from U.S. income tax under IRC Section 871(h)(2). The 10 percent stock ownership threshold is determined under the attribution rules of IRC Section 318(a).
- Dividends from corporations to NRA investors and the NRA investor's distributive share of partnership interests (whether or not there is an actual distribution from the partnership) are subject to a 30 percent tax rate under IRC Section 871(a), unless a lower tax treaty rate is applicable.

9.111 Stock owned in a foreign corporation is not U.S. situs property of an NRA and is exempt from U.S. estate taxes. Consequently, foreign investors can be shielded from U.S. estate tax liability on their U.S. auto dealership investments by using a tiered organizational structure. Direct ownership of the foreign investor's dealership interest would be held by a U.S. domestic corporation, which in turn would be wholly owned by a foreign corporation whose sole shareholder is the foreign investor. For income tax purposes, auto dealership earnings and/or dividends would be taxable at the U.S. domestic corporation level. Dividends distributed to the foreign parent corporation, if any, would be subject to a 30 percent tax or lower treaty rate, if applicable. Taxation of distributions from the foreign corporation would be governed by the appropriate foreign jurisdiction. However, for U.S. estate tax purposes, the foreign corporate stock is the only property considered owned by the NRA under this organizational structure. Since the foreign corporate stock is not U.S. situs property, the NRA's entire auto dealership investment is not subject to U.S. estate taxation.

9.112 The above organizational structure is best for investments in real property and other non-income producing investments that can be expected to appreciate in value during the period of ownership. The

[10] Revised Uniform Limited Partnership Act Section 201.

[11] See, for example, Florida Statute Sections 608.401 through 608.471, known as "The Florida Limited Liability Company Act".

accumulation of income by the U.S. corporation from a successful dealership operation, without dividend distributions to the foreign parent, could easily lead to an accumulated earnings tax problem, as provided for under IRC Section 531. Consequently, an LLC or limited partnership having a single level of income taxation would be more appropriate for an NRA's investment in dealership operations likely to produce substantial amounts of income. The regulations, however, are unclear regarding the situs of an NRA's ownership of a partnership interest for U.S. estate tax purposes.

9.113 The income tax and estate tax tradeoffs need to be evaluated carefully when structuring an NRA's investment in an auto dealership. A combination of the above structures could be appropriate under certain circumstances. Real property, land and buildings, and other non-income producing assets could be placed in a tiered organizational structure for estate tax purposes without incurring adverse income tax consequences. The investment in dealership operations could be placed in an LLC or limited partnership resulting in a single level of income taxation. An arm's length rental agreement between the organizational structures for the use of equipment and real property should be established to avoid IRC Section 482 issues.

Tax Considerations

9.114 An assessment of the tax considerations must be made before selecting the appropriate business form. Taxation of income is different for each business form and can have a dramatic effect on the return on the investment of the principals.

9.115 The tax considerations to be evaluated include the taxable events at time of organization of the entity, choice of fiscal year, taxation of income, deductibility of losses, allocation of losses and tax credits among the entity and its principals, distributions to the principals, changes in ownership, and liquidation and termination of the business.

9.116 This section discusses these tax considerations as they apply to the:

- Subchapter C Corporation
- Subchapter S Corporation
- Limited Partnership
- Limited Liability Company (LLC)
- Limited Liability Partnership (LLP)

9.117 Subchapter C Corporation. A C corporation's income is subject to taxation at two levels. Income is taxed first at the corporate rates which are a maximum of 35 percent effective with the Omnibus Budget Reconciliation Act of 1993 (OBRA '93).[12] Dividend distributions to shareholders are taxed at the individual shareholder's tax rate which is a maximum of 36 percent, plus a 3.6 percent surtax for individuals with taxable income in excess of $250,000, for a total tax rate of 39.6 percent.[13] The corporation is also subject to the alternative minimum tax (AMT) at the 20 percent rate on alternative

[12] IRC Section 11, as amended by the OBRA '93, Section 13221.

[13] IRC Section 1, as amended by OBRA '93, Sections 13201 and 13202.

minimum taxable income which is creditable against regular tax in future years.[14] The overall tax burden to both the corporation and shareholders can be minimized through effective salary, bonus and executive compensation programs that result in a deduction to the corporation and taxable income to the individuals. These programs assume the shareholder is an active employee in the dealership, otherwise, the salary could be considered excessive compensation by the IRS and reclassified as a dividend distribution.

9.118 A C corporation can select any desired fiscal year prior to filing its first tax return covering a period of twelve months or less. Subsequent changes in fiscal year must be approved by the IRS unless an automatic change can be made under Regs. 1.442-1(c) or Rev. Proc. 92-13. An election to become an S corporation may require the corporation to change to a calendar year or an approved fiscal year,[15] and possibly pay a LIFO tax "toll charge," and remain liable for corporate-level built-in gains tax.

9.119 Operating losses are retained by the corporation and can be carried back (up to 3 years) or forward to offset taxable income in other years.[16] Similarly, tax credits, charitable contribution deductions, and the IRC Section 179 election to expense certain purchases of assets can be used only by the corporation.

9.120 Incorporation may be structured as either a taxable or nontaxable event. In a nontaxable transaction, the shareholder contributes money or property to a corporation in return for shares of stock.[17] The shareholder's basis in the stock is the sum of the money contributed plus his or her basis in any contributed property. Neither the corporation nor the shareholder incur a tax at this time. The transaction can be structured as a taxable event if the shareholder sells property to the corporation. Also, the transaction is taxable to the extent the shareholder has gain from the receipt of money, as well as stock, from the corporation for contributed property.[18] A taxable transaction may be desirable if the shareholder has other capital losses, which can offset gains realized from the sale of property to the corporation. Recognition of losses on the shareholder's sale of property to the corporation may be disallowed because of the rules for related-party transactions.[19]

9.121 Distributions to the shareholders from earnings and profits of the corporation are treated as dividends subject to tax at the shareholder level. When the corporation has no accumulated earnings and profits, distributions are treated as a nontaxable return of capital to the extent of the shareholder's basis in his or her stock. Distributions in excess of the shareholder's basis are taxed as capital gains.[20] Unreasonable accumulation of earnings and a failure to make dividend distributions can result in an additional tax of 39.6 percent on accumulated earnings and profits in excess of the business' needs.[21] Distributions of appreciated property are taxed at the corporate level as if the property had been sold at a gain to the shareholder and then taxed again as a dividend at the shareholder level.[22] Redemptions of a

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14 IRC Section 55.

15 IRC Section 1378 and 444.

16 IRC Section 172.

17 IRC Section 351.

18 IRC Section 351(b).

19 IRC Section 1239.

20 IRC Section 301(c).

21 IRC Section 531, as amended by OBRA '93, Sections 13201 and 13202.

22 IRC Section 312(b) and 301.

shareholder's entire interest in the corporation is subject to capital gain treatment rather than being taxed as a dividend.[23]

9.122 Subchapter S Corporation. S corporations were intended to provide small businesses with a simplified form of organization. However, a corporation must timely file an election with the IRS to be taxed as an S corporation and all shareholders must agree to the election.[24] Once the election is approved, the S corporation must strictly comply with the requirements to retain the benefits of S corporation status.

9.123 To maintain S corporation status, S corporations must comply with the following requirements at all times:[25]

- The corporation must be a U.S. domestic corporation.
- The maximum number of shareholders is 35, however, husband and wife count as one shareholder. A partnership of S Corporations could effectively be used to allow an unlimited number of owners.
- All shareholders must be individuals, except that a qualified trust may be treated as if the shares were owned by the individual beneficiary.
- Only one class of stock may be issued and outstanding. Differences in voting rights among the shares are permitted, however, each share must have the same right to share in the profits and liquidation.
- A nonresident alien cannot be a shareholder.

9.124 Incorporation may be either a taxable or nontaxable transaction, the same as a C corporation. An S corporation is treated as a "pass through" entity for tax purposes. Income is generally taxed at the shareholder level only. Each shareholder is taxed prorata on his or her share of income. S corporation losses are deductible by the individual shareholder on his or her personal tax return to the extent of his or her basis in the stock of, and loans made directly to, the corporation. Losses in excess of basis are suspended at the corporate level until the shareholder has basis.[26] Similarly, the separately stated items, such as interest income, tax credits, charitable contribution deductions, and IRC Section 179 deductions are passed through to the shareholder proportionate to his or her stock ownership.[27] Though the S corporation is not subject to alternative minimum tax, tax preferences are passed-through, prorata, to shareholders and are included in their individual AMT computations.

9.125 A shareholder's basis is comprised of his or her capital contributions plus any loans to the corporation. Basis is increased for the shareholder's share of income, both taxable and nontaxable, and

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[23] IRC Section 302(b).

[24] IRC Section 1362(b). The election is made by filing Form 2553 Election by a Small Business Corporation.

[25] IRC Section 1361(b).

[26] IRC Section 1366(d).

[27] IRC Section 1366(a)(1) which references IRC Sections 702(a)(4) and (6) applicable to partnerships. Also see IRC Section 1366(b).

is reduced by his or her share of losses, distributions, and nondeductible noncapitalized corporate expenses, such as the disallowed portion of meals and entertainment expenses.[28]

9.126 Although deductible by a C corporation, the cost of employee fringe benefits provided by an S corporation to a more-than-2% shareholder-employee for services rendered to the corporation are non-deductible to an S corporation, as fringe benefit costs, and are taxable as income to the shareholder-employee.[29]

9.127 Employee fringe benefit expenditures for the more-than-2% shareholder-employee are considered compensation and are reported on Form W-2 issued to the individual. These costs are deducted by the corporation as either officer's compensation or salaries and wages, depending on whether the shareholder-employee is a corporate officer or only a shareholder. Amounts paid for health insurance coverage are also reported separately on Form W-2. A more-than-2% shareholder may be able to deduct up to 25 percent of these amounts as a self-employed health insurance deduction in computing adjusted gross income on his or her individual income tax return.

9.128 A C corporation dealership, using LIFO (last-in, first-out) inventory methods, that changes to an S corporation is required to include the LIFO recapture amount in gross income of the C corporation, for the last taxable year before the change to S status. Any increase in tax that results from including the LIFO recapture in income is payable in four equal installments. The first installment is paid on or before the due date of the tax return for the last C corporation year. The remaining installments are due on or before the due date of the corporation's tax return for three succeeding tax years.[30] Also, the built-in gains tax pursuant to IRC Section 1374 may apply to other low-basis corporate assets that have appreciated in value. IRC Section 1374 applies to both tangible and intangible dealership assets.

9.129 Prior to the OBRA '93, individual tax rates were lower than corporate tax rates, giving S corporation status a decided tax preference for shareholders. New individual maximum tax rates of 36 percent plus an additional 10 percent surtax compared to a maximum corporate rate of 35 percent have a mitigating effect on the tax advantage of S corporations. Consequently, the tax consequences of both organizational forms need to be analyzed carefully prior to incorporation and/or in contemplation of terminating the S corporation election.

9.130 **Limited Partnership.** Limited partnerships (LP) are typically used as a syndication vehicle to attract investors. An LP must have at least one general partner, which may be either a C or S corporation. A corporate general partner limits the liability of its shareholders, however, the corporation must maintain a minimum account balance of at least 1 percent of total positive capital account balances for the partnership or $500,000, whichever is less.[31] The net worth of the corporate general partner must equal or exceed the lesser of 10 percent of the total capital contributions or $1 million. If there is more than one corporate general partner, the contributions and net worth of each are aggregated to determine if the

[28] IRC Section 1367.

[29] IRC Section 1372(a) and (b). The S corporation is treated as a partnership in applying the income tax rules relating to employee fringe benefits.

[30] IRC Section 1363(d).

[31] Rev. Proc. 89-12, Section 4.03.

requirements are met.[32] Limited partners are liable for the debts of the partnership only to the extent of their capital contributions.

9.131 LPs are pass-through entities. All income, gains, losses, deductions, tax credits and tax preference items and other separately stated items are passed through to the partners and are taxed at the individual rates on their personal tax returns.

9.132 Limited Liability Company (LLC). LLCs are hybrid entities that combine the corporate characteristic of limited liability and the pass-through characteristics of partnerships. For federal income tax purposes, an LLC is taxed as a partnership. However, some states, such as Florida, tax an LLC as a corporation. Treatment as a partnership for federal tax purposes is dependent upon the LLC lacking at least two of the following three corporate characteristics; otherwise the LLC can be classified as a corporation. The three characteristics are:[33]

- Free transferability of interests
- Centralized management
- Continuity of life

9.133 The LLC concept originated in Wyoming. Subsequent to the IRS ruling to treat an LLC as a partnership for federal income tax purposes, other states began enacting LLC statutes. Today, most states have enacted LLC statutes and recognize this form of doing business. Taxation of LLCs at the state level varies, however, and not all states follow the IRS ruling that recognizes an LLC as a partnership for state income tax purposes. The IRS has issued rulings for many states' LLC statutes' conformity with partnership income tax status.

9.134 LLCs offer their members the advantage of liability limited to their investment in the company. The restrictions on S corporation shareholders and classes of stock do not apply to LLCs. Other corporations, partnerships, trusts, foreign entities and nonresident aliens may be LLC members. An LLC can issue multiple classes of stock, common and preferred, as well as convertible debt, warrants and stock rights.

9.135 The specific provisions of limited liability company statutes vary by state. Some states place limits on the LLC's continuity of life and transferability of interests thereby ensuring federal income tax treatment as a partnership. Other states provide more flexibility in their statutes, which can cause the LLC to be characterized as a corporation unless appropriate provisions are made in the articles of organization.

9.136 Free transferability of interest is lacking when an assignee or transferee cannot become a substitute member and acquire all the attributes of the transferring member's interest without approval by the remaining members of the assignment or transfer.[34] Free transferability of interest was ruled to be lacking where the required portion of consenting membership consisted of non-transferring members entitled to

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[32] Rev. Proc. 89-12, Section 4.07.

[33] IRC Regulation 301.7701-2(a)(3).

[34] IRS Letter Rulings 8937010, 9030013, 9052039 and 9119029.

receive a majority of the non-transferred profits interest in the LLC[35] or where the non-transferring members hold a majority of the capital interests in the LLC.[36]

9.137 An LLC, however, possesses the free transferability of interest if, on presentation of written notice, the transferee becomes a substitute member and acquires all the attributes of the member's interest in the LLC without any required approval by other members or LLC management for the substitution to become effective.[37]

9.138 The IRS has ruled that free transferability of interest is lacking if a member can assign or transfer his or her interest to a nonmember, or if the assignee or transferee does not become a substitute member and does not acquire all the attributes of the member's interest, unless approved by all the remaining members. This ruling was applied to LLCs organized under the statutes in Alabama, Arizona, Colorado, Delaware, Florida, Illinois, Louisiana, Nevada, Rhode Island, Virginia, and West Virginia.[38]

9.139 An LLC lacks centralized management when its articles of organization provide that management is reserved to its members in proportion to their interests in the LLC.[39] However, when the members designate a manager or managers, the LLC will possess the corporate characteristic of centralized management.[40]

9.140 The IRS has ruled that LLCs possess the corporate characteristic of centralized management where under the LLC's articles of organization, the LLC is managed by its elected members for LLCs formed under the statutes in Alabama, Arizona, Colorado, Delaware, Florida, Illinois, Louisiana, Nevada, Oklahoma, Rhode Island, Utah, Virginia, and West Virginia.[41]

9.141 LLCs may lack continuity of life when the applicable statute provides that the LLC dissolves upon the expiration of a fixed term for the duration of the LLC, unanimous consent of the members, or the death, retirement, resignation, expulsion, bankruptcy, dissolution of membership or termination of a member's continued membership. However, the IRS has ruled that an LLC possessed continuity of life where dissolution could be avoided by a majority vote of the members.[42]

9.142 Other IRS rulings concluded that continuity of life was not assured when agreement of all or a portion of the remaining members was required to continue the business when a member ceased to be a member under statutes enacted in Alabama, Arizona, Colorado, Delaware, Florida, Illinois, Louisiana,

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[35] Utah LLC. Rev. Rul. 93-91.

[36] Oklahoma LLC. Rev. Rul. 93-93.

[37] Rev. Rul. 93-38.

[38] Rev. Rul. 94-6, Rev. Rul. 93-93, Rev. Rul. 93-6, Rev. Rul. 93-38, Rev. Rul. 93-53, Rev. Rul. 93-49, Rev. Rul. 94-5, Rev. Rul. 93-30, Rev. Rul. 93-81, Rev. Rul. 93-5, Rev. Rul. 93-50.

[39] IRS Letter Ruling 9010027 and Rev. Rul. 93-38.

[40] Rev. Rul. 88-76.

[41] Rev. Rul. 94-6, Rev. Rul. 93-93, Rev. Rul. 93-6, Rev. Rul. 93-38, Rev. Rul. 93-53, Rev. Rul. 93-49, Rev. Rul. 94-5, Rev. Rul. 93-30, Rev. Rul. 93-92, Rev. Rul. 93-81, Rev. Rul. 93-91, Rev. Rul. 93-5, Rev. Rul. 93-50.

[42] IRS Letter Ruling 9010027.

Nevada, Oklahoma, Rhode Island, Texas, Utah, Virginia, and West Virginia.[43] However, an LLC organized under the Delaware LLC Act was ruled to possess continuity of life because the LLC agreement provided for continuance of the LLC after termination of the continued membership of a member.[44]

9.143 The conversion of a partnership into a newly-created LLC, which will be taxed as a partnership, is not a taxable event when the partner's share of partnership liabilities does not change as a result of the conversion. Under these circumstances, no gain or loss results to the partnership, the LLC, or any of the partner/members.[45] However, if the conversion causes a reduction in the partner's share of partnership liabilities, the partner will be treated as receiving a distribution equal to the amount of the reduction. The tax effects of the deemed distribution will be determined under the rules for partnership distributions.

9.144 Limited Liability Partnership (LLP). An LLP is a modified form of a general partnership in which partners are afforded certain protection from liability for the acts of other partners. The intent of this form of entity is that no partner will be individually liable for obligations or liabilities arising from errors, omissions, negligence, malpractice, or wrongful acts committed by another partner or by an employee, agent, or representative of the partnership. Partners, however, continue to be liable for other debts of the partnership and certain acts under the partner's supervision and control that are excluded from the limited liability protection.

9.145 LLP statutes distinguish between "Protected Acts", which are errors, omissions, negligence, malpractice, or wrongful acts of a specific partner and for which liability protection is afforded the other partners, and "Acts Outside Limited Liability", for which the partner remains joint and severally liable. Acts Outside Limited Liability include debts or obligations of the LLP arising from any cause other than a Protected Act, including errors, omissions, negligence, malpractice, or wrongful acts committed by the partner or any person under the partner's direct supervision, and any debts for which the partner has agreed to be liable.

9.200 DEALERSHIP ACQUISITIONS/DIVESTITURE

9.201 Competitive pressures within the auto industry and other related factors can be expected to create a continuing level of turnover in the ownership of dealerships. Acquisition/divestiture of dealerships may take place through direct transfer of dealership assets or through the transfer of stock ownership in the dealership corporation. For a stock acquisition, the acquiring dealer may elect to revalue the underlying assets to their fair market value based upon the price paid for the stock.[46]

9.202 The purchase price consideration for the acquisition of the assets of a dealership must be allocated over four classes of assets using a residual method.[47] The purchase price allocation is reported to the IRS on Form 8594, Asset Acquisition Statement Under Section 1060. Both the seller and the buyer must

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[43] Rev. Rul. 94-6, Rev. Rul. 93-93, Rev. Rul. 93-6, Rev. Rul. 93-38, Rev. Rul. 93-53, Rev. Rul. 93-49, Rev. Rul. 94-5, Rev. Rul. 93-30, Rev. Rul. 93-92, Rev. Rul. 93-81, IRS Letter Ruling 9210019, Rev. Rul. 93-91, Rev. Rul. 93-5, Rev. Rul. 93-50.

[44] Rev. Rul. 93-38.

[45] Rev. Rul. 84-52, IRS Letter Rulings 9210019, 9010027, 9119029 and 9029019.

[46] IRC Section 338.

[47] IRC Section 1060 and IRC Regulation Section 1.1060-1T.

complete and attach Form 8594 to their respective tax returns for the year of sale. The Form also requires the price paid for licenses, covenants not to compete and management contracts with the seller to be reported. Subsequent amendments to purchase price allocations by either party must be reported on an amended Form 8594 stating the reasons for the change. The four asset classes are:

- ***Class I***: cash, demand deposits and similar accounts in banks, savings and loan associations, and other similar items. Any consideration remaining after the reduction for Class I assets is to be allocated to the other assets transferred in the order of their asset class.
- ***Class II***: certificates of deposit, U.S. government securities, readily marketable stock or securities, and other similar items.
- ***Class III***: all assets (other than Class I, II, or IV assets) both tangible and intangible (whether or not depreciable or amortizable), including furniture and fixtures, land, buildings, equipment, accounts receivable, and covenants not to compete.
- ***Class IV***: intangible assets in the nature of goodwill and going concern value.

9.203 The allocation of the purchase price, whether stated explicitly in the closing statement or implied in the negotiations of the parties, should not exceed the fair market value of the assets on the purchase date. In connection with the examination of the dealer's tax return, the IRS may challenge the dealer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including the lack of adverse tax interests between the parties. Any amounts determined to be overvaluations of an asset will be reclassified as goodwill by the IRS. Consequently, the burden of proof to substantiate the fair market value of assets through appraisals and other means rests with the dealer.

9.204 Historically, the allocation of purchase price to intangible assets, such as covenants not to compete, consulting agreements, and customer lists, has been a source of continuing controversy between dealers and the IRS.

9.205 OBRA '93 provides for a 15-year amortization period for intangible assets acquired in connection with the purchase of a dealership. Prior to OBRA '93, intangibles were amortized over their respective useful lives, and goodwill and going concern value was non-amortizable. As a result, dealers would attempt to allocate as much of the residual purchase price as possible to intangibles, such as covenants not to compete, consulting agreements and customer lists, to minimize the amount of non-amortizable goodwill. Under OBRA '93, goodwill is amortizable over the same 15 years as other intangibles. As a result, the level of conflict between dealers and the IRS should be reduced substantially in this area.

9.206 Intangible assets encompassed by IRC Section 197, which are likely to be part of a dealership acquisition/divestiture, include the following:[48]

- ***Goodwill and Going Concern Value***: Goodwill is the portion of the dealership acquisition price attributable to the expectancy that customers will continue to patronize the dealership. Going concern value is the portion of the dealership acquisition price that attaches to dealership property and represents the dealership's ability to continue to produce income even though

48 OBRA '93 Section 13228.

there has been an ownership change. Both goodwill and going concern value are residual amounts of the acquisition price after all other tangible and intangible assets have been valued.

- ***Workforce, Information Base and Customer Based Intangibles*:** Workforce represents any value assignable to the employees of the dealership in place at the time of acquisition and encompasses such things as specialized skills, education and training. Workforce implies a cost to the dealership of having to replace those skills due to employee turnover. Information base intangibles include items such as dealership books and records and customer lists. Customer based intangibles encompass the value of anticipated future business from existing relationships with customers.

- ***Covenants Not To Compete*:** This category includes covenants not to compete and other similar arrangements entered into in connection with the acquisition of the dealership. Also included are agreements for consulting and other services from the previous owners to the extent that the payments for these services exceed reasonable compensation for the services provided.

- ***Franchises*:** The term franchise means the dealership's right to sell and service a specific manufacturer's automobile lines within a specified geographic area, as defined by the terms and conditions of the dealership's agreement with the automobile manufacturer. Contingent payments, such as payments based on gross receipts or dealership profits, for the franchise may be part of the cost of the acquisition. However, amounts paid for contingent serial payments for the franchise are not covered by IRC Section 197.

9.207 Under OBRA '93, the dealer's tax planning opportunities appear to be limited to management consulting agreements, provided the compensation under such agreements is not considered to be excessive compensation. Presumably, the current nebulous definition of "excessive compensation" will carryover under OBRA '93 provisions. Note that Social Security (including the "no ceiling" Medicare tax) applies to such payments.

9.208 Consulting agreements providing reasonable compensation for services rendered will be currently deductible as paid. Such agreements do not come under the IRC Section 197 intangibles umbrella. Dealers are advised to document thoroughly the services provided by the seller under a consulting agreement to substantiate the reasonableness of the compensation paid. This documentation should include the number of hours and dates services were rendered, the business purpose of the service, and the dealer personnel involved.

9.209 OBRA '93 is generally effective for all property acquired after August 10, 1993. However, dealers may elect pre-OBRA '93 law to apply to property acquired after that date, provided that property was acquired under a binding written contract that was in effect before August 10, 1993 and continually in effect until the property was acquired.

9.210 OBRA '93 provides dealers with a window of tax planning opportunity to elect to apply the provisions of IRC Section 197 to intangibles acquired after July 25, 1991. Dealers in this situation should compare the tax benefits of their current schedule of intangible amortization, recognizing that goodwill and going concern value is not amortizable, to the 15-year amortization provided under IRC Section 197.

9.211 Dealers must have made this election on the tax return that includes 8/10/93. Failure to make a timely election precludes any subsequent making of the election in the event of an IRS examination of the purchase price allocated to intangibles. If the election is made, amended tax returns must be filed for the prior years affected by the recomputation of the amortization deduction. Dealers should carefully assess the risks of IRS reclassification of those intangibles to non-amortizable goodwill versus electing the 15-year amortization provisions of IRC Section 197.

9.212 Exhibit 9.901 provides a copy of Form 8594, *Asset Acquisition Statement Under Section 1060.*

9.213 OBRA '93 requires the purchase price allocable to IRC Section 197 intangibles be specified on the Form 8594 instead of the amount of the purchase price allocable to goodwill and going concern value.

9.300 INVENTORY ISSUES

LIFO Inventory Issues

9.301 General. The LIFO (last-in, first-out) inventory method treats inventory sold in any period as the most recently acquired. Cost of goods sold for any period consists of costs related to the most recent inventory acquisitions. In an inflationary economy, the effect of LIFO is to price goods sold at their current replacement value and to afford some relief against artificial inventory profits. Inventory valued under LIFO consists of several "layers", each deemed to have been acquired in a different year and valued at the prevailing price level for the year of acquisition. Effective tax planning preserves the lower- priced LIFO layers, thereby deferring income recognition for tax purposes. In years when inventory sold exceeds inventory acquired, the LIFO layers are eroded and deferred income is recognized. This practice is referred to as "taking a dip in the LIFO pool" and can produce artificial profit levels that may mask other cost management problems of the dealership, as well as resulting in an increased tax liability.

9.302 There are two principal types of LIFO accounting methods with which the dealer needs to be concerned:

- The ***Unit Method*** or ***Specific Goods Method*** is intended for inventories that consist of large numbers of homogeneous "items" that change infrequently. Each item is treated as a separate inventory pool. As items change, the LIFO pool is liquidated and the deferral of income from that LIFO pool is lost. Under this method, the IRS argument is that whenever a specific car or truck model is discontinued, the LIFO reserve for that model must be recaptured as additional income.
- The ***Dollar Value LIFO Method*** treats inventory in terms of dollars rather than individual items. As a result, dollars are the common denominator for valuing inventory. Under the dollar value method, items are used to calculate the amount of inflation versus quantity fluctuations annually. Therefore, the effect of quantity decreases in one car model may be offset by increases in another model.

9.303 Under either LIFO accounting method, the following two principal methods of pricing inventory may be employed:

- The ***Double Extension Method*** requires each item in the ending inventory of a pool to be priced at its current year and its base year cost. Base year cost is the first year LIFO was elected by the dealer. The requirement that the inflation index be computed on all items includible in ending inventory is a major drawback to this method for dealers. Because the inflation ratio is determined as a function of the initial base year cost, computing the inflation index on new items entering the inventory in later years is burdensome and often impossible.
- The ***Link Chain Index Method*** compares current costs with prior year costs and "links" the current inflation index with a cumulative index to convert inventory to base year cost. Sampling techniques are allowed under this method, thereby simplifying the computational burden. However, sampling is **NOT** permitted under the Alternative LIFO Method described below.

9.304 Historically, agreement among CPAs, the IRS and third party LIFO computational services on the terminology relating to the LIFO methods and inventory pricing procedures and its application to dealerships has been lacking. The precedent for the prevailing IRS view that separate pools should be established for new cars and new trucks is found in the Fox Chevrolet[49] and Richardson Investments[50] cases. A recent private letter ruling has expanded on this concept with respect to minivans, which were ruled to be generally includible in the new car pools. Further, taxpayer treatment of parts, options and accessories, used vehicles, sampling techniques employed in inventory pricing, the use of averaging approaches to inventory repricing, and the definition of new inventory items were all areas of ongoing controversy with the IRS. Moreover, guidance from the IRS on acceptable standards for applying LIFO methods to dealerships consisted primarily of what was not acceptable rather than providing direction on methods and procedures that would be acceptable to the IRS.

9.305 In response to these problems, the IRS issued Revenue Procedure (Rev. Proc.) 92-79 in September, 1992, and set forth the ***Alternative LIFO Method*** for valuing new car and light-duty truck inventories. Moreover, the IRS offered complete immunity from audit all LIFO computations for the years preceding the year of change to the Alternative LIFO Method, provided the dealer timely filed a request to change to the new method. Dealers who did not change to the Alternative LIFO Method can expect to be held to much higher, and possibly unrealistic, "comparability" standards in computing LIFO indices. Rev. Proc. 92-79 does not address LIFO issues regarding parts, options and accessories, or used vehicles.

9.306 Dealers converting to LIFO inventory methods must file Form 970, *Application To Use LIFO Inventory Method*, with the tax return for the first tax year the LIFO method is used. Expansion of LIFO inventory methods to other inventory categories not included under previous elections require filing of a separate Form 970 for the additional categories to be covered under LIFO. LIFO elections may be revoked only with IRS consent.[51]

9.307 The following section discusses the requirements of Rev. Proc. 92-79. A discussion of the variety of LIFO approaches and the risks and planning opportunities associated with LIFO variations for parts, options and accessories, or used vehicles is beyond the scope of this Manual.

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49 Fox Chevrolet, Inc. Maryland v. Commissioner, 76 T.C. 708 (1981), acq., 1984-2 C.B. 1.

50 Richardson Investments, Inc., and Subsidiaries v. Commissioner, 76 T.T. 736 (1981).

51 IRC Regulation Section 1.472-3(a).

9.308 Alternative LIFO Method (Rev. Proc. 92-79). The Alternative LIFO Method set forth in Rev. Proc. 92-79 became effective September 28, 1992. This method provides a simplified approach for determining ending inventory and costs of goods sold for new cars and new light-duty trucks. This approach encompasses:

- Separate LIFO pools for new automobiles and light-duty trucks.
- A simplified comprehensive dollar-value, link chain based approach.
- Using manufacturer's base model code numbers to define items of inventory.
- Using current-year cost of a "new" item as the prior-year cost for the item.
- Defining new items as:
  - any new or reassigned manufacturer's model code number caused by a change in an existing vehicle
  - a manufacturer's model code created or reassigned because the classified vehicle did not previously exist
  - a change to a vehicle platform resulting in a change in track width or wheel base
- Using the actual base vehicle cost of each specific vehicle in ending inventory to compute the LIFO pool index. Adjustments for options, accessories, or other costs are not required. The LIFO pool index is applied to the total cost, including options, accessories and other costs of all vehicles in the pool at the end of the year. Separately stated advertising charges are not inventoriable costs per a recent IRS private ruling.

9.309 Rev. Proc. 92-79 provides for the expeditious consent to change to the Alternative LIFO Method for dealers timely filing a Form 3115 requesting such change with the IRS National Office before December 31, 1992. After the close of the first taxable year ending after December 31, 1992, dealers changing to the Alternative LIFO method and who are not under examination on the date the Form 3115 is filed may do so only under the applicable provisions of Rev. Proc. 92-20, which requires filing Form 3115 within the first 180 days after the start of the year of change. Dealers under examination on the date the Form 3115 is filed may only request to make this change under the applicable provisions of Rev. Proc. 92-20, which may involve filing under the "90-day audit window." Dealers adopting this method at the time the dealer makes the election to use the dollar-value LIFO inventory method must complete and file a statement of election made on Form 970 with the tax return for the first applicable tax year.

9.310 Under the Alternative LIFO Method, the inflation index is computed with reference to invoices for every vehicle in ending inventory. Sampling of vehicles in the pool is not permitted. Copies of the vehicle invoices used in the computations should be saved indefinitely. The LIFO value of inventory for the pool is computed under the following 14-step approach as set forth in Rev. Proc. 92-79:

- **Step 1:** Obtain the actual invoice for each vehicle in ending inventory.
- **Step 2:** For each LIFO pool, group all the invoices from Step 1 by item category using the manufacturer's base model code numbers broken down as finely as possible under the rules and definitions of Rev. Proc. 92-79, Section 4.02.

- **Step 3:** For each item category, total the dealer's base vehicle costs of all vehicles within each category from Step 2.

- **Step 4:** Within each pool, compute the average base vehicle cost for each item category by dividing the result from Step 3 for each item category by the number of vehicles in the item category. This average base vehicle cost for each item will be used in Step 6 of the succeeding year's computations.

- **Step 5:** For each pool, compute the total current-year base vehicle cost of the pool by adding together the separate item category totals from Step 3.

- **Step 6:** For each pool, compute the total base vehicle cost of the ending inventory at prior-year's base vehicle cost.
  First, multiply the number of vehicles in the current year's ending inventory for each item category by the average base vehicle cost of the same item category from Step 4 of the prior year's inventory calculation.

  If the same item was not in existence in the prior year's ending inventory and was not stocked by the dealer at the end of that year, then the repricing reference may be made to the manufacturer's price list which provides dealer purchase prices using the list in effect as of the beginning of the last month of the prior taxable year.

  Finally, add together the total prior-year base vehicle cost of all of the item categories.

- **Step 7:** For each pool, compute the current-year (annual) index by dividing the amount from Step 5 by the amount from Step 6.

- **Step 8:** For each pool, compute the cumulative index by multiplying the current-year index from Step 7 by the cumulative index at the end of the preceding year (from Step 8 of the preceding year's computation). In the year of change to the Alternative LIFO Method, the prior year cumulative index is 1.00.

- **Step 9:** For each pool, compute the total current-year total-vehicle cost by adding together the total invoice cost, including installed options, accessories, and other inventoried cost(s) of all of the vehicles in inventory at the end of the current year.

- **Step 10:** For each pool, compute the total cost of the current-year's ending inventory at base-year cost by dividing the total current-year total-vehicle cost of all of the vehicles in ending inventory from Step 9, by the cumulative index from Step 8.

- **Step 11:** For each pool, determine if there is an increment for the current year by comparing the total cost of the pool's current-year ending inventory at base-year cost, from Step 10, with the total cost of the pool's preceding year's ending inventory at base-year cost, using the amount from Step 10 of the preceding year's calculation. If the amount from Step 10 of the current year's calculation is greater, there is an increment.

- **Step 12:** For each pool, value the current year's increment at current year cost by multiplying the increment amount from Step 11 by the cumulative index from Step 8.

- **Step 13:** If there is no increment for a pool, but rather a liquidation (also referred to as a decrement), reduce the LIFO layers in reverse chronological order until the liquidation is fully absorbed.

- **Step 14:** For each pool, add together the current year's increment, if any, at current-year cost and the prior year's increments at each prior year's current-year cost to compute the total LIFO value for the pool.

  The result in Step 14 is the total LIFO value for the pool. The LIFO reserve for the pool is determined by subtracting the result on Step 14 (the ending inventory at LIFO) from the result in Step 9 (the ending inventory at actual cost).

9.311 The exhibit in section 9.902 illustrates an example of the Alternative LIFO Method computations as prescribed under Rev. Proc. 92-79.

9.312 The exhibit in section 9.903 provides a partially completed Form 970, *Application To Use LIFO Inventory Method*, for a dealer changing to LIFO when making the election to use the Alternative LIFO Method.

9.313 The exhibit in section 9.904 provides a partially completed Form 3115, *Application for Change in Accounting Method*, to be filed under Section 6.01 of Rev. Proc. 92-79 for dealers electing the Alternative LIFO Method for tax years after the close of the first taxable year ending after December 31, 1992.

LIFO Conformity Requirement

9.314 Dealers using the LIFO inventory method must satisfactorily establish that they have not used any other inventory method in determining income, profit, or loss for any taxable year in which the LIFO inventory method applies. Moreover, dealers using LIFO must not use any other inventory method for purposes of obtaining credit or reporting to shareholders or partners. Certain exceptions as provided in IRC Regulations Section 1.472-2(e) are considered to comply with the LIFO conformity requirement, as follows:[52]

- The use of an inventory method other than LIFO is permitted for ascertaining information reported as a supplement to or explanation of the dealer's primary presentation of the income, profit, or loss for a taxable year in credit statements or financial reports, including preliminary and unaudited financial reports. Information reported on the face of the dealer's financial income statement for a taxable year is not considered a supplement to the income, profit, or loss for the taxable year in credit statements or financial reports. Information reported in notes to a dealer's financial income statement is considered a supplement to or explanation of the dealer's primary presentation of income, profit, or loss for the period covered by the income statement if all notes to the financial income statement are presented together and if they accompany the income statement in a single report.[53]
- The use of an inventory method other than LIFO is permitted to ascertain the value of the dealer's inventory of goods on hand for purposes of reporting the value of such inventories as assets. The dealer may disclose the value of inventories on a balance sheet using a method other than LIFO and will be considered to comply with the LIFO conformity requirement.

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[52] IRC Regulation Section 1.472-2(e)(1).

[53] IRC Regulation Section 1.472-2(e)(3).

However, the disclosure of income, profit, or loss for a taxable year on a balance sheet issued to creditors, shareholders, or partners is considered not to comply with the LIFO conformity requirement if such income information is ascertained using an inventory method other than LIFO and such income information is for a taxable year for which the LIFO is used for Federal income tax purposes. If the disclosure is made in the form of either a footnote to the balance sheet or a parenthetical disclosure on the face of the balance sheet, the disclosure is not considered to comply with the LIFO conformity requirement.[54]

- The use of an inventory method other than LIFO for purposes of ascertaining information reported in internal management reports.[55]
- The use of an inventory method other than LIFO for purposes of issuing reports or credit statements covering a period of operations that is less than a full taxable year for which the LIFO method is used for Federal income tax purposes. A series of credit statements or financial reports is considered a single statement or report covering a period of operations if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the full year period. Consequently, any year end adjustments to the LIFO reserve must be made in the twelfth month and not as thirteenth month adjustments.[56]
- The dealer's use of a costing method or accounting method is permitted to ascertain income, profit, or loss for credit purposes or for purposes of financial reports if such costing method or accounting method is consistent with the LIFO inventory method and the LIFO conformity requirement, regardless of whether such costing method or accounting method is used for Federal income tax purposes. Such examples include the computation of inventory costs under the full absorption inventory method, any method of establishing pools for inventory under the dollar-value LIFO inventory method, any method of determining the LIFO value of a dollar-value inventory pool, any method of determining a price index to be used with the index or link chain method of valuing inventory pools, or the treatment of transfers of inventory between affiliated corporations.[57]

9.315 Failure to comply with the LIFO conformity requirements may result in the dealer's loss of the LIFO deferral of income recognition and require that the entire LIFO reserve be recognized in income for the tax year in which the violation occurs. Further, a violation of the conformity requirement may result in the IRS compelling an involuntary change from LIFO in the year of violation or any later tax year.

9.316 As provided by the conformity regulations, any financial report issued by an auto dealer that covers a 12-month period or that could be combined with other financial reports to cover a contiguous 12-month period must include the LIFO adjustment. For example:

[54] IRC Regulation Section 1.472-2(e)(4).

[55] IRC Regulation Section 1.472-2(e)(1)(iii).

[56] IRC Regulation Section 1.472-2(e)(6).

[57] IRC Regulation Section 1.472-2(e)(8).

- A manufacturer's December financial statement for a fiscal year auto dealer should include the LIFO adjustment because the factory statement most likely will cover a calendar year 12-month period.
- December statements for calendar year auto dealers and 12th-month statements for fiscal year dealers must include the LIFO adjustment because the statement will cover a 12-month period.
- Thirteenth month statements for fiscal and calendar year auto dealers must include the LIFO adjustment because 13th-month statements include the 12 months of operations plus subsequent adjustments.

9.317 The LIFO adjustment must be reflected on the income statement because the conformity requirement states the auto dealer must establish that in ascertaining "income, profit, or loss" for any year the LIFO election is effective, the dealer has not used an inventory method other than LIFO.

- Running a "net LIFO adjustment" through retained earnings on the balance sheet presumes that "income, profit, or loss" on the corresponding income statement was not determined under a LIFO inventory method and would cause a conformity violation.
- Conformity requires the LIFO adjustment be reflected in income in the year it occurs, not in the subsequent year.

9.318 Although not explicitly stated in the regulations, valuing inventory on the LIFO method implies that the LIFO adjustment should be reflected through cost of goods sold to properly value inventory on the financial statements.

9.319 Recently, there has been a great deal of attention given to the LIFO conformity issue by the IRS as part of its ongoing examination program focusing on the use of LIFO by automobile dealers. Manufacturers' factory financial statements, which follow a prescribed format, may provide for recording a LIFO adjustment either in the cost of goods sold section or as an "other deduction" on the financial statement.

9.320 The issue has been raised as to whether reporting the LIFO adjustment as an "other deduction" on the factory financial statement rather than as an adjustment to cost of goods sold constitutes a conformity violation. Also, an issue has been raised as to whether the use of an estimate of the LIFO adjustment anywhere on the factory financial statement also constitutes a conformity violation.

9.321 Two recently issued IRS technical advice memorandums conclude that the issuance of 12 monthly statements by a dealer to its manufacturer that are prepared on a FIFO basis, constitutes a conformity violation and subjects the dealer to termination of its LIFO election. Other technical advice requests involving LIFO conformity issues are reportedly pending with the IRS National Office in Washington and, when issued, may provide a clearer indication of the IRS's position on LIFO conformity.

Uniform Capitalization Rules

9.322 The Uniform Capitalization Rules (UCR), enacted by the Tax Reform Act of 1986 (TRA 1986), address the degree to which direct and indirect costs must be treated as inventoried costs. Using an inventory method of accounting, costs related to producing, acquiring, storing and handling inventories are not deducted until the amounts earned upon sale of inventories are included in income. As a result, costs that would otherwise be deductible currently must be capitalized and cannot be recovered until the related inventory items are sold. Prior to the Tax Reform Act of 1986, the dealer's inventory costs were the invoice price of the automobile, transportation and freight charges, and any other charges incurred directly in acquiring the inventory.

9.323 An exception to UCR is made for dealers with an average annual gross receipts over the prior three years of $10 million or less. However, receipts of related entities are counted in determining the total gross receipts. These dealers are subject to the pre-TRA 1986 inventory rules requiring only the invoice price of the goods, transportation costs, and other acquisition costs be inventoried.

9.324 UCR requires that direct labor and indirect costs related to (1) off-site storage and warehousing, (2) purchasing, (3) handling, and (4) general and administrative costs related to these three activities be inventoried. All expenses related to each of these cost categories must also be inventoried.

9.325 As a result of UCR, dealers must maintain cost systems that identify and record the additional inventoried costs. Dealers must make judgments regarding the activities that fall into the different cost accumulation categories. Costs benefiting more than one activity must be allocated to each related activity. Support functions, such as personnel or payroll, must be allocated among the activities.

9.326 UCR requires all costs of "off-site" storage and warehousing related to goods acquired for resale to be treated as inventory costs; however, "on-site" storage costs are not required to be inventoried. Costs attributable to purchasing activities, such as placing purchase orders and establishing and maintaining vendor contracts, must be inventoried. Handling and processing costs, such as freight-in, unloading transport vehicles, and recording automobiles in inventory, are also required to be inventoried. General and administrative costs related to these activities, including accounting, data processing services, security services, legal services, and management and supervision costs, must be inventoried as well. These general and administrative costs, referred to as "mixed service costs" are allocated between resale activities and other activities for which costs may be deducted currently.

9.327 Costs other than those related to off-site storage and warehousing, purchasing, handling, and related general and administrative costs are not required to be inventoried. Sales, marketing and advertising expenses are currently deductible. Costs related to warranty claims may be deducted currently. Interest costs associated with floor planning, depreciation, taxes and insurance are also not required to be inventoried.

9.328 Dealers may elect to use the ***simplified resale method***, the ***alternate simplified resale method***, or the ***modified resale method*** to allocate additional UCR costs between ending inventory and cost of goods sold. The variations in these three methods relate to the treatment of storage, handling, and related general and administrative expenses. Dealers may elect to use the ***simplified resale service cost method*** to determine the inventoried portion of mixed service department costs. Furthermore, dealers using one of these simplified methods may elect to use an ***optional purchasing allocation method***.

9.329 The ***simplified resale method*** is an add-on method to the dealer's pre-UCR costing method which allocates resale costs between cost of goods sold and ending inventory essentially by using an overall burden rate for the entire dealership. This burden rate is the ratio of additional UCR costs to total purchases made during the year. The burden rate is then multiplied by the amount of current year purchases in ending inventory to determine the amount of current year UCR resale costs that remain in ending inventory. The following formulas illustrate this method:

$$\frac{\text{Current-Year UCR Resale Costs}}{\text{Current-Year Purchases}} \times \text{Current-Year Purchases in Ending Inventory} = \text{UCR Resale Costs in Ending Inventory}$$

9.330 If the dealer is using LIFO and there is no LIFO increment for the current year, as determined before applying UCR, all of the year's resale costs are deducted currently and none remain in ending inventory. Under the FIFO inventory method, none of the resale costs are allocated to goods in ending inventory that were acquired before the current year. The objection to this method is that storage and handling costs relate to both beginning inventory and current year purchases. However, the formula allocates costs only to current purchases thereby increasing the percentage of current year resale costs that remain in ending inventory.

9.331 The ***alternative simplified resale method*** considers the possibility that opening inventory balances can accumulate increments of storage, handling and related general and administrative costs. Under this method, a separate allocation ratio is computed for handling and storage costs, including the related mixed service costs that includes both beginning inventory and current year purchases in the denominator of the ratio. The ratio is multiplied by all ending inventory to determine the total storage and handling costs in ending inventory. The purchase cost allocation is computed the same as under the simplified resale method. The following formulas illustrate this method:

Storage and Handling Cost Allocation:

$$\frac{\text{Current-Year Storage and Handling Costs}^{*}}{\text{Beginning Inventory}^{**}\text{ plus Current-Year Purchases}} \times \text{All Ending Inventory}^{***} = \text{Storage and Handling Costs in Ending Inventory}$$

Purchasing Cost Allocation:

$$\frac{\text{Current-Year Purchasing Costs}^{*}}{\text{Current-Year Purchases}} \times \text{Current-Year Purchases in Ending Inventory} = \text{UCR Resale Costs in Ending Inventory}$$

* Includes related general and administrative costs.

** For LIFO dealers, this is the LIFO carrying value, not current year cost.

*** For LIFO dealers, this includes the entire LIFO carrying value, not just the current year's layer. For FIFO dealers, this includes current purchases and goods which are in both beginning and ending inventory.

9.332 The Technical and Miscellaneous Revenue Act of 1988 provided for the ***modified resale method***. Under this method the denominator in the allocation ratio is the sum of beginning inventory plus current year purchases. The ratio is then multiplied by the current year purchases in ending inventory to determine the storage and handling costs in ending inventory. Again, the purchase cost allocation is computed the same as under the simplified resale method as follows:

Storage and Handling Cost Allocation:

Current-Year Storage and Handling Costs* / Beginning Inventory** plus Current-Year Purchases	×	Current Year Purchases in Ending Inventory	=	Storage and Handling Costs in Ending Inventory

* Includes related general and administrative costs.

** For LIFO dealers, this is the LIFO carrying value, not current year cost.

9.333 A dealer who elects to use one of the "simplified" resale methods may also elect to use the ***simplified resale service cost method*** to determine the inventoried portion of mixed service costs. This election is made independent of the election to use one of the three simplified resale methods described above. However, the election of a simplified resale method is a prerequisite to electing the simplified resale service cost method. The amount of mixed service costs included in additional UCR resale costs is determined by multiplying the total amount of mixed service costs incurred by the dealer during the year by the ratio of:

(1) the sum of the labor costs allocated to the off-site storage, purchasing, and handling activities to

(2) the total of all labor costs incurred by the dealer excluding the total amount of labor costs included in the mixed service costs.

9.334 Dealers who are using another simplified method may also elect to use the ***optional purchasing allocation method*** to allocate labor costs of personnel performing more than one function between the purchasing and non-purchasing functions of those personnel. This allocation may not be used with respect to personnel providing general and administrative services that benefit or are incurred by reason of purchasing functions. The formula for allocating labor costs of personnel directly performing purchasing functions follows:

(1) If less than one-third of the person's activities relate to a purchasing function, none of the labor costs attributable to that person may be allocated to a purchasing function.

(2) If more than two-thirds of the person's activities relate to a purchasing function, all of the labor costs attributable to that person may be allocated to a purchasing function.

(3) In all other cases, an allocation of costs between functions must be made.

9.335 Dealers whose gross receipts exceed the $10 million limitation are required to change to UCR under the transition procedures described in the regulations. Dealers who adopt an erroneous UCR method or who file two erroneous tax returns under UCR must request IRS approval before changing to a proper UCR method. The initial change to UCR is mandated by statute and dealers may change to UCR automatically with the filing of Form 3115, *Application for Change in Accounting Method*. Any subsequent changes in UCR methods require the filing of Form 3115 to obtain IRS approval for the change.

Used Car Inventory Rules

9.336 Used cars taken in trade by the dealer as partial payment on the sale of another vehicle may be valued for inventory purposes at the average wholesale price listed by an official used car guide at the time of the trade-in.[58] Any differences between the recorded inventory value and the value allowed the customer at the time of trade-in represents a reduction in the selling price of the new car.[59]

9.337 Prices in the used car market are volatile and subject to geographic variations, demand for specific car models, options and accessories, the condition of the used car, and other factors. The dealer's method of valuing used car inventory may be either at cost or lower of cost or market.

9.338 Under the cost method, a used car's cost at the time of trade-in can be documented based on official used car guide published prices. Used cars purchased at wholesale are valued at the wholesale purchase price plus related acquisition costs. Using the cost method of valuing inventory precludes the dealer from taking write-downs at year end based on general price declines in the used car market.

9.339 Under the lower of cost or market method, a used car's cost at the time of trade-in is based on official used car guide published prices — the same as under the cost method. The inventory value of used cars purchased at wholesale is established in the same manner as under the cost method. However, at year end, used car inventories may be written down to current market value based on official used car published prices to reflect declines in inventory value from the time the vehicles were acquired.

9.340 The election to use lower of cost or market is made by checking the appropriate box on Schedule A of Form 1120, *U.S. Corporation Income Tax Return*, Form 1120S, *U.S. Income Tax Return for an S Corporation*, or Form 1065, *U.S. Partnership Return of Income*, for the first taxable year to which used car inventory applies. Subsequent changes in used car inventory valuation methods require filing a Form 3115 and obtaining IRS approval for the change.

9.341 Year end inventory write downs under the lower of cost or market method must be documented by the dealer. Each used car must be separately revalued based on official used car guide published prices at year end to substantiate inventory value declines. The amount of the write-down permitted is the difference between the lower year-end market value and the cost established at time of trade-in. Short-cuts to this procedure, such as valuing the entire inventory at cost and then deducting an arbitrary percentage for estimated market decline, are not permitted. Sampling techniques whereby a representative sample of used cars are selected and the percent reduction in the sample is then applied to the entire inventory are also not permitted.

9.342 Recent increases in used car prices have prompted many dealers to elect LIFO for used car inventory. The LIFO election for used car inventory may be made by attaching Form 970, *Application*

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[58] Rev. Rul. 67-107 1967-1 CB 115; Brooks-Massey Dodge Inc., (1973) 60 TC 884.

[59] Adams Motor Co., (1926) 4 BTA 589(A).

To Use LIFO Inventory Method, to the tax return for the tax year in which the election is made. Prior IRS approval is not required for this LIFO election.

9.343 The used car LIFO election requires restating beginning year inventory at cost, which will normally result in the recognition of income for auto dealers using the lower of cost or market method. For tax purposes, the income will be recognized over a three-year period pursuant to Section 3(1)(a) of Revenue Procedure 92-20.

9.400 SELECTED INCOME AND EXPENSE RECOGNITION ISSUES

Extended Warranty and Multi-Year Service Contracts

9.401 As the complexity of automotive technology and the associated maintenance costs have increased, dealers have begun offering customers extended warranty and multi-year service contracts. Typically, the terms of these contracts extend beyond the manufacturer's provided warranty period and provide for similar maintenance coverage as provided during the original warranty period. The dealer then purchases an insurance contract from an unrelated third party that insures the dealer against maintenance costs that will be incurred during the extended warranty period.

9.402 Typically, the dealer, rather than the manufacturer, is the obligor or principal under the contract. The dealer is considered to be insuring the associated contract risk with a third party and therefore the dealer is not the agent for the manufacturer.

9.403 In past audits, the IRS examined the dealer's accounting treatment of these contracts and concluded that for tax purposes many dealers were incorrectly timing the recognition of income and expense related to extended warranty contracts. Initially, the IRS sought to require dealers to recognize all income in the year of sale of the warranty contract and to amortize the cost of the insurance contract in the years covered by the warranty contract. For example, suppose a dealer sold an extended warranty contract for $800 covering the fourth and fifth years and then purchased insurance from the manufacturer's subsidiary for $400. The IRS, in PLR 9218004, intended to require the dealer to recognize $800 income in the first year and then allow $200 of amortized expense in each of the fourth and fifth years. The IRS rejected the dealer's contention that it was merely an agent of the manufacturer and was thereby entitled to deduct the $400 premium expense against the $800 income in the year of sale.

9.404 Industry-wide opposition to the IRS's position led to the announcement of Rev. Proc. 92-97, which allows dealers to expeditiously change their procedure on accounting for warranty contracts. Under Rev. Proc. 92-97, dealers purchasing a multi-year service warranty insurance policy in connection with the sale of a multi-year service warranty contract by paying a lump-sum premium must capitalize the premium amount and amortize it over the life of the insurance policy, including the years covered by the initial warranty period. Dealers were permitted to apply for an expeditious change in their accounting methods. As further encouragement to do so, the IRS granted dealers not under audit for this issue protection from audit on warranty contract issues for tax years prior to 1992.

9.405 Subsequently, the IRS offered dealers under audit for extended warranty contracts a compromise settlement in Announcement 92-127.

9.406 Dealers were provided an option under Revenue Procedure 92-98 to elect a new method of accounting — ***the service warranty income method*** — for advance payments received in connection with multi-year service warranty contracts. The option provided for the deferral of income recognition to the extent of the "qualified advance payment amount" (QAPA).[60] The QAPA is the amount paid to an unrelated third party within 60 days of receipt for insurance costs associated with the policy insuring the dealer's obligations under the contract. Revenue from the contract is included in taxable income in the year payment from the customer is received. The difference between the contract amount received and the gross profit is eligible for deferral. However, income must be increased by an imputed amount of interest due to the deferral period allowed the dealer. The imputed interest does not increase basis in Sub-Chapter S Corporations' shareholders' stock.

9.407 Deferred income, under Rev. Proc. 92-98, is reported as if all warranty service contracts were sold on the first day of the taxable year, whereas the cost amortization required under Rev. Proc. 92-97 begins when the dealer pays the insurer.

9.408 The election to use the service warranty income method is available to accrual method dealers with respect to qualified advance payment amounts received on service warranty contracts:[61]

- that are fixed-term service arrangements with respect to a motor vehicle purchased by the customer
- that are separately priced, such that customers have the option to purchase the service warranty for an expressly stated amount separate from the price of the vehicle
- for which the service period begins in the taxable year the advance payment is received or upon expiration of a fixed-term manufacturer's warranty beginning in the taxable year the advance payment is received
- for which the dealership purchases a policy that constitutes insurance for federal income tax purposes from an unrelated third party to insure its obligation under the service warranty contract
- for which the dealer makes payment to the unrelated third party insurer within 60 days after receipt of the advance payment for the entire amount of the insurance costs associated with the policy insuring its obligations under the service warranty contract

9.409 To qualify for the service warranty income method, the dealership must either (1) have never previously received advance payments under service warranty contracts prior to the taxable year of its election under Rev. Proc. 92-98, or (2) use the proper method of accounting for advance payments received under its service warranty contracts. Moreover, the dealer must be in compliance with Rev. Proc. 92-97.[62]

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60 Rev. Proc. 92-98, Section 3.02.

61 Rev. Proc. 92-98, Section 4.01.

62 Rev. Proc. 92-98, Section 7.

9.410 Implementing the service warranty income method requires the dealer to take the following actions each year:

- Identify the contracts obligating the dealer to provide warranty services that meet the requirements of Rev. Proc. 92-98.
- Categorize all contracts, obligating the dealer to provide warranty services, sold during the year by length of the service contract and by month sold within each category.
- Summarize the total receipts for each category.
- Summarize the total monies remitted to third parties for each category by month the remittance is made.
- Determine the gross profit for contracts in each category and the amount of the qualified deferral.
- Compute the amount of imputed income based on the applicable federal funds rate (short term or mid-term depending upon the length of the contract up to a maximum of six years in duration) and the amount of deductible amortization for the tax year.

9.411 Illustration No. 9-1 provides an example of the recognition of income under Rev. Proc. 92-97 and Rev. Proc. 92-98 for a typical extended warranty service contract.

Dealer Reserves

9.412 The typical automobile sale is made under some type of conditional sales contract involving an installment note. The face amount of the note includes the unpaid balance of the purchase price, plus the finance charges. The common practice among dealers is to endorse or sell the installment note to a finance company. The finance company holds back a portion of the finance commission due to the dealer. This holdback is referred to as a "dealer reserve".

9.413 The following are three major types of agreements that may be made between the automobile dealer and a finance company:

- ***Repurchase Plan*:** This plan provides that the dealer will repurchase any automobile that is repossessed by the finance company for the amount of the unpaid balance of the note. The finance company must repossess the automobile and turn it over to the dealer; otherwise, the dealer is released from all responsibility and any loss must be borne by the finance company.
- ***Recourse Plan*:** Under this plan, the dealer endorses to the finance company "with recourse" all notes received from automobile purchaser. In the event of default, the dealer is obligated for the unpaid balance of the note, and the dealer receives the repossessed automobile. The finance company's recourse would be against the dealer rather than against the automobile.
- ***Non-Recourse Plan*:** Upon the sale of the conditional sales contract to the finance company, the dealer would endorse the installment note "without recourse" and would be relieved of all liability. The finance company becomes the owner of any automobile that is repossessed and

cannot look to the dealer for any balance due on the note. The dealership immediately receives payment for the purchase price of the automobile, as well as the finance commission it is due.

9.414 Dealers usually receive a commission from finance companies for the installment notes sold to them. The commissions may be paid immediately to the dealer or withheld and credited to a "dealer reserve holdback" account to cover contingent bad debts. The amounts withheld by the finance company must be reported as income by the dealer, since the dealer is on the accrual basis of accounting.[63]

[63] IRC Regulation Section 1.451-1, Also see IRC Sections 446 and 453 and IRC Regulation Section 1.446-1 and 1.453-2.

ILLUSTRATION NO. 9-1

ANALYSIS OF REV. PROC. 92-97 AND REV. PROC. 92-98

FACTS: During 1993, a calendar-year accrual method dealership sells a dealer obligor extended warranty contract for $1,000 to a customer purchasing an automobile. The contract is for a period of five years and does not run currently with the manufacturer's warranty. The dealership then pays $400 to an unrelated third party to insure its obligation under the contract.

Sales Price of the Contract	$ 1,000
Cost of Dealer's Insurance	400
Gross Profit	$ 600

Recognition of Income Under PLR 9218004

	Total	1993	1994	1995	1996	1997
Contract Income	$1,000	$1,000	$ 0	$ 0	$ 0	$ 0
Cost of Insurance	(400)	0	0	0	(200)	(200)
Taxable Income or (Deduction)	$ 600	$1,000	$ 0	$ 0	$(200)	$(200)

Recognition of Income Under Rev. Proc. 92-97

	Total	1993	1994	1995	1996	1997
Contract Income	$1,000	$1,000	$ 0	$ 0	$ 0	$ 0
Cost of Insurance	(400)	(80)	(80)	(80)	(80)	(80)
Taxable Income or (Deduction)	$ 600	$ 920	$ (80)	$ (80)	$ (80)	$ (80)

Recognition of Income Under Rev. Proc. 92-98 (Service Warranty Income Method)

	Total	1993	1994	1995	1996	1997
Income:						
Gross Profit	$ 600	$ 600	$ 0	$ 0	$ 0	$ 0
Cost of Insurance	400	80	80	80	80	80
Total Contract Income	1,000	680	80	80	80	80
Imputed Income	100	20	20	20	20	20
Total Income	1,100	700	100	100	100	100
Deductions:						
Cost of Insurance	(400)	(80)	(80)	(80)	(80)	(80)
Taxable Income	$ 700	$ 620	$ 20	$ 20	$ 20	$ 20

Imputed income is computed using the IRS's applicable mid-term interest rate for January, 1993 since a five-year contract is within the period covered by the mid-term rate. For this illustration, a 10 percent interest rate is used.

9.415 Arrangements between the dealer and the finance company may vary regarding the portion of the commission retained by the finance company or the level of holdback reserves the finance company retains.

9.416 The ***Hansen Rule*** governs the dealer's recognition of income from the sale of installment notes to finance companies. The U.S. Supreme Court holds that the finance company's holdback of the dealer's reserve is immediately taxable to the dealer. The Hansen Rule applies to the unearned finance charge the finance company credits to the reserve and to the portion of the automobile purchase price retained by the finance company. Moreover, the Hansen Rule applies even if the dealer endorses the installment note to the finance company "without recourse".[64]

Buy Here/Pay Here and Internal Financing

9.417 Buy Here/Pay Here (BHPH) programs are aimed at a market segment of customers whose credit worthiness does not meet the standards of banks and other traditional lenders. Although higher risks are associated with these customers, these programs, if managed properly, can have a positive impact on the dealer's bottom line profits.

9.418 Implementation and management of an effective BHPH program requires an understanding of the tax consequences of these transactions. Under prior tax laws, the dealer could finance customer purchases and recognize profits from the sale as the customer paid the installment note. Recent tax law changes, however, require an accrual method dealer to recognize the entire profit from the sale of the automobile in the year of sale. Interest income is taxed as earned over the term of the loan.

9.419 The BHPH programs have potential pitfalls for the dealer. First, the customer's down payment may not cover the tax liability for the profit from the transaction. In addition, the repossession rate for these customers is likely to be higher than for other customers, increasing the potential for future losses.

9.420 Avoiding BHPH programs altogether may not be an advisable marketing strategy. However, increasing the required payment frequency to weekly or semi-monthly from the traditional monthly payment and aggressively tracking and claiming bad debt deductions may add administrative costs without a resulting benefit. These tradeoffs should be evaluated before implementing a BHPH program.

9.421 Alternatively, the dealer can establish a related separate unconsolidated financing corporation to shelter some of the current year profit. Under this scenario, the dealer would sell the customer's installment note to the related financing corporation at fair market value, which would be the value an unrelated finance company would offer for the receivable. The transaction would result in a loss to the dealer, thereby reducing the amount of current year income recognized. Related-party transaction rules limit the amount of loss the dealer can recognize to the amount of income from the sale of the automobile. The finance company would recognize income from the installment note as payments are received from the customer. The overall result to the dealership is a deferral of a portion of current year income which would be recognized as the customer pays the installment note. The following example illustrates this concept.

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[64] Com. v. Hansen, John, (1959, S Ct) 360 US 446, revg Hansen, (1958, CA 9) 258 F2d 585, revg TC Memo 1957-113.

Dealer Sale of Automobile to Customer:

Sales Price	— Installment Note	$4,500
	— Cash Downpayment	500
Total Sale Price		5,000
Less: Cost		(3,500)
Profit		1,500
Loss on Sale of Installment Note (see below)		(900)
Current Year Income Recognized by Dealer		$ 600

Dealer Sells Customer Note to Related Finance Company:

Discounted Receivable Sales Price	$3,600
Less: Dealer's Cost of Note	(4,500)
Dealer's Loss on Note	$ 900
Deferred Income of Related Company	$ 900

9.422 The Internal Revenue Code Regulations provide an exception to the rule that losses resulting from the sale or exchange of property between members of the same controlled group may be deferred and recognized when the property is transferred outside the controlled group. This exception applies to the sale of receivables between members of a controlled group that do not file a consolidated tax return. However, the exception applies only to receivables originally acquired as the result of a sale of goods or services at a gain to a party outside the controlled group. If an auto dealer sells such a receivable at fair market value and at a loss to a financing corporation member of the controlled group, the loss deferred is limited to the extent it exceeds the gain on the underlying sale.[65]

Finance and Insurance Income

9.423 Finance income from the reselling of customer installment notes to banks and third party lenders and commissions from credit life and disability insurance sold to customers represents additional sources of income for the dealer.

9.424 Dealers provide financing to customers of new and used cars through local banks and other third party lenders. Under the usual arrangement, the customer signs an installment note at the time of purchase for the balance due on the automobile. The installment note provides for a fixed schedule of payments over the term of the note. The total amount due on the note includes the purchase price of the automobile plus finance charges at a stated annual percentage rate of interest.

9.425 The dealer then resells the customer's installment note to a bank or finance company at a discount (effectively a lower annual percentage rate of interest). The amount of finance charges represented by the interest rate differential is income to the dealer. Historically, banks and finance companies have paid the

[65] IRC Regulation Section 1.267(f)-1T(e).

dealer the amount of finance income at the time the note is transferred. Payment to the dealer is made with the provision that if the customer pays off the note early and receives a reduction in the finance charges under the note, the bank has recourse against the dealer for a pro rata return of the financing income paid to the dealer. In some instances, the bank escrows the finance income due the dealer in anticipation that customer installment notes will be paid off early.

9.426 Finance income to the dealer from reselling the customer installment note is recognized in full at the time the note is transferred to the third party. Although the dealer may establish a reserve for anticipated repayments to the bank for financial statement purposes, no deduction for amounts reserved is permitted for federal income tax purposes. Repayments of finance income are recognized for tax purposes only at the time repayment to the bank occurs.

9.427 Banks and third party lenders are offering dealers a variation of the above arrangements which address the problems of the dealer's contingent liability for repayment of unearned finance income. Under this new approach, the bank will offer the dealer a discounted percentage, for example 75 or 80 percent, of the finance income the dealer would otherwise receive. In return for accepting this lower amount, the dealer is relieved of any obligation for repayment to the bank. Again, income to the dealer is recognized in full for federal income tax purposes.

9.428 Commissions from the sale of credit life and disability insurance to customers are similar to those for finance income. Dealers receive a commission from the insurance underwriter whenever a credit life or disability policy is sold to a customer in conjunction with the financing of an automobile. The dealer receives the commission at the time the policy is written. However, if the customer cancels the policy before the end of the policy term and receives a refund of premiums paid, the dealer is obligated to return the portion of unearned commissions to the insurance underwriter. However, for federal tax purposes, all insurance commission income is recognized when received. Any reserves established for financial statement purposes are non deductible for income tax purposes.

Environmental Cleanup Costs

9.429 Recent IRS pronouncements concerning the deductibility of environmental cleanup costs have been favorable to auto dealers, however, clear guidelines to be used in determining the appropriate treatment of cleanup costs — ordinary expense deduction or capital expenditure — have not been established. Deductibility of cleanup expenses depends on the facts and circumstances of each individual situation. The burden of proof that cleanup costs meet the criteria for deductibility rests with the auto dealer.

9.430 To be currently deductible, environmental cleanup costs must meet four criteria, otherwise the cost must be capitalized. These criteria are:[66]

- The expenditure must be incidental to the property.
- The expenditure must not materially add to the value of the property.
- The expenditure must not appreciably prolong the useful life of the property.
- The purpose of the expenditure must be to keep the property in ordinarily efficient operating condition.

[66] IRS Regulations Section 1.162-4.

9.431 The IRS relies heavily on *Plainfield-Union Water Company v. Commissioner, 39 T.C. 333 (1962)*, in determining whether cleanup costs can be deducted currently or should be capitalized. In this case, the Tax Court held that the costs of changing the lining of water pipes from tar to cement were currently deductible by the taxpayer. The court concluded that any expenditure which returns property to the original state before the situation prompting the expenditure arose is considered a repair if it does not increase the value, usefulness, or longevity of the property. The test for determining an increase in property value was established by comparing the value of the property before the expenditure arose to the value after the expenditure.

9.432 Applying the above criteria to various environmental cleanup situations, the IRS has ruled:

- The costs of removing and replacing asbestos insulation in manufacturing equipment was a capital expenditure because the asbestos removal increased the value of the equipment by making it more attractive to potential buyers and decreasing the taxpayer's liability risk from asbestos exposure.[67]
- The costs of removing PCBs were not incidental to the property and were required to be capitalized. These costs were determined to be part of a general plan of rehabilitation and as a result the property was inherently more valuable after the PCB removal than when the property was contaminated. However, the IRS permitted a deduction for legal fees incurred to defend against Environmental Protection Agency (EPA) and state regulatory claims arising out of dumping the toxic waste, the costs to defend against private lawsuits arising out of the same activities and the costs to seek insurance reimbursements pertaining to the activities. Additionally, the IRS would not determine the deductibility of the costs of environmental audits and the development of a PCB compliance manual.[68]
- The costs of encapsulating asbestos-containing materials in a warehouse were considered incidental repair costs that did not materially add to the value of the property nor increase its useful life. However, the costs of removing asbestos in a boiler house which was converted to leased office space was required to be capitalized since the asbestos removal increased the property value and adapted the property to a different use.[69]

9.433 Revenue Ruling 94-38, the most recent IRS pronouncement, allows a current deduction for the costs of removing contaminated soil.[70] The IRS concluded that the cleanup cost incurred did not produce permanent improvements, provide significant future benefits, increase the land's useful life, or adapt the land to a new and different use. Since the *Plainfield-Union* tests were met, the costs were currently deducible.

9.434 A key circumstantial factor affecting the deductibility of the cleanup costs appears to be whether the property had been previously uncontaminated so as to be able to establish a value before contamination occurred. Property constructed with asbestos was contaminated from the outset thereby precluding the determination of a value before contamination. The *Plainfield-Union* tests imply that a value before contamination must be established to substantiate the cleanup costs did not materially add to the value of the property. Hazardous waste removal suggests that the property existed previously in an uncontaminated state and that a value before contamination can be established.

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[67] IRS Letter Ruling 9240004.

[68] IRS Letter Ruling 9315004

[69] IRS Letter Ruling 9315004.

[70] Rev. Rul. 94-38 (June 3, 1994).

9.435 Based on IRS Letter Ruling 9315004 and Revenue Ruling 94-38, the costs of annual maintenance to keep property free from environmental contaminants would presumably be deductible currently as annual maintenance costs.

9.500 CASH REPORTING — FORM 8300 AND RECORDS RETENTION

Cash Reporting — Form 8300

9.501 The Tax Reform Act of 1984 enacted legislation requiring the receipt of more than $10,000 in cash in a single or series of related transactions to be reported to the IRS. This legislation was intended to target money laundering and other illegal activities, as well as the "underground" cash economy in the United States.

9.502 IRC Section 6060I requires a dealer, who in the course of its trade or business receives more than $10,000 in cash in a single transaction or a series of related transactions, to file Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, by the 15th day after the transaction. Transaction details reported on Form 8300 include the name, address and taxpayer identification number of the person from whom the cash was received, the amount of cash received, and the date and nature of the transaction.[71]

9.503 The definition of "cash" was expanded by regulations issued in 1991 and applies to all amounts received on or after February 3, 1992. Cash encompasses coin and currency of the United States or any other country. Other monetary instruments considered to be cash are a cashier's check (by whatever name, including "treasurer's check" and "bank check"), bank draft, traveler's check, or money order having a face amount of $10,000 or less.[72]

9.504 The final regulations provide three exceptions to this expanded definition of cash:[73]

- ***Loan Exception***: A monetary instrument is not treated as cash if the instrument constitutes the proceeds of a loan from a bank. The dealer may rely on a copy of the loan document, a written statement from the bank, or similar documentation to substantiate that the instrument constitutes loan proceeds.
- ***Installment Sale Exception***: A monetary instrument is not treated as cash if the instrument is received in payment on a promissory note or an installment sales contract, including a lease, provided the dealer ordinarily uses such instruments in connection with customer sales and the total amount of payments received on or before the 60th day after the sale date does not exceed 50 percent of the sales price of the sale.
- ***Down Payment or Deferred Payment Plan Exception***: A monetary instrument is not treated as cash if the instrument is received pursuant to a payment plan requiring one or more down payments and the payment of the balance by a date no later than the date of the sale. However, this exception applies only if the dealer customarily uses these payment plans in the normal course of sales to customers and the instrument is received more than 60 days before the date of the sale.

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[71] IRC Regulations Section 1.6050I-1(e).

[72] IRC Regulation Section 1.6050I-1(c)(1)(ii).

[73] IRC Regulation Section 1.6050I-1(c)(1)(iv), (v), and (vi).

9.505 Special reporting rules are provided for multiple payment transactions. If the first payment exceeds $10,000, the payment must be reported within 15 days of receipt. If the payment is less than $10,000, the dealer must combine the initial payment with subsequent payments made within one year. When the payments, alone or combined, exceed $10,000 within the one year period, these payments must be reported within 15 days of the date they exceed $10,000.[74]

9.506 Reporting requirements also apply to agents who receive cash on behalf of the dealer. For example, an agent who collects delinquent accounts receivable for the dealer must report cash receipts in excess of $10,000 from a particular customer's account even though the proceeds of the collection are credited to the dealer's account. However, if the agent turns over the cash to the dealer within 15 days of receipt and discloses all of the required reporting information to the dealer, the agent is not required to file Form 8300. The reporting burden is transferred to the dealer.[75]

9.507 In addition to filing Form 8300 for reportable cash transactions, the dealer is required to provide each person named in the Form 8300 with a written statement identifying the dealer's name and address, the total amount of reportable cash received, and that the information was furnished to the IRS. This statement must be provided by the dealer no later than January 31 of the year following the calendar year in which the cash is received.[76]

9.508 Penalties for failure to comply with the cash reporting requirements can be substantial and, as a result, the IRS provides educational programs targeted at dealers in an effort to raise the general awareness of the resulting civil and criminal penalties. The penalty for failure to file Form 8300 and to furnish required statements to taxpayers is $50 per failure, subject to a maximum of $250,000 for any calendar year. An exception to the penalty is available if the failure is due to reasonable cause and not willful neglect.

9.509 If the failure to file reports with the IRS is due to intentional disregard of the filing requirements, the penalty is the greater of $25,000 or the amount of cash received in the transaction or related transactions, but not more than $100,000. Civil and criminal penalties are provided for willful violations of reporting requirements, which includes the structuring of transactions for the purpose of evading the cash transaction reporting requirement.[77]

9.510 Section 9.905 provides a sample Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*.

Records Retention

9.511 Auto dealers are required to retain records of business transactions material to the administration of the Internal Revenue Code and the accurate determination of tax liability. Records are required to be retained so long as their contents may be material in the administration of any internal revenue law.[78] All

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[74] IRC Regulation Section 1.6050I-1(b).

[75] IRC Regulation Section 1.6050I-1(a)(3)(ii).

[76] IRC Regulation Section 1.6050I-1(f).

[77] IRC Section 6721.

[78] IRC Section 6001 and IRC Regulation Section 1.6001-1.

computer records comprising all machine-sensible data media used for recording, consolidating, and summarizing accounting transactions and records are within the scope of these provisions.[79]

9.512 An auto dealer having assets of $10 million or more is required to comply with the record retention requirements set forth in Revenue Ruling 71-20 and as updated by Revenue Procedure 91-59. Dealers having assets of less than $10 million are required to comply with these provisions when the required information retained in machine-sensible form and is not in hardcopy books and records or when machine-sensible records were used for computations that cannot be reasonably verified or recomputed without using a computer, such as LIFO inventories.[80] For purposes of determining the $10 million value of asset, a controlled group of corporations is considered to be one corporation and all assets of all members of the group are aggregated.

9.513 The District Director of the Internal Revenue Service has the authority to enter into records retention limitation agreements identifying specific records within an auto dealer's computer based systems which are to be subject to the records retention requirements of Revenue Procedure 91-59. Typically, the records retention limitation agreement is the result of an evaluation of the auto dealer's computer systems conducted by an IRS Computer Audit Specialist.[81]

9.514 Revenue Procedure 91-59 sets forth detailed procedures of retaining computer records. Computer systems documentation is within the scope of the revenue procedure and requires that documentation include record formats and codes used to represent information, flowcharts for systems and computer programs, computer source program listings and detailed charts of accounts for the dealer's accounting systems. Auto dealers employing data base management system (DBMS) software packages may be required to extract and retain transactional data in sequential files which would be suitable for use with computer audit sampling techniques.[82]

9.515 The provisions of Revenue Procedure 91-59 and any records retention limitation agreements entered into with the Internal Revenue Service do not relieve the dealer of responsibility to retain hardcopy records that are created or received in the ordinary course of business as required by existing law and regulations. Hardcopy records may be retained in microfiche or microfilm format,[83] however, such records are not a substitute for machine-sensible records required to be retained.[84]

[79] Rev. Rul. 71-20.

[80] Rev. Proc. 91-59, Section 3.

[81] Rev. Proc. 91-59, Section 4.

[82] Rev. Proc. 91-59, Section 5.

[83] Rev. Proc. 81-46.

[84] Rev. Proc. 91-59, Section 6.

9.516 Record retention cycles for other dealership records will vary according state and local law requirements, the nature of the documents themselves, and the relevancy to ongoing dealership operations. The following is intended to be a guide to record retention for various dealership documents.

Permanent Retention

Audit reports of accountants
Cash books and charts of accounts
Cancelled checks for important payments
Contracts and leases still in effect
Correspondence on legal and other important matters
Deeds
Mortgages and bills of sale
Depreciation Schedules
Financial statements (end-of-year)
General and private ledgers (and end-of-year trial balances)
Insurance records, current accident reports, claims, and current policies
Invoices (copies) for all new cars & new trucks held in inventory at the end of any tax return year for which the alternative LIFO method (Rev. Proc. 92-79) is effective.
Journals
Minute books of directors and stockholders
Property appraisals by outside appraisers
Property records
Tax returns and worksheets, revenue agents' reports and other documents determining income tax liability
Trademark and Servicemark registrations

Three Year Retention

General correspondence
Employee personnel records (after termination)
Employment applications
Expired insurance policies
Internal audit reports
Internal reports
Petty cash vouchers
Physical inventory tags
Savings bond registration records of employees

Seven Year Retention

Accident reports and claims
Accounts payable ledgers and schedules
Accounts receivable ledgers and schedules
Cancelled checks
Expired contracts and leases
Expense analysis and expense distribution schedules
Inventories of products, materials and supplies
Invoices to customers
Notes receivable ledgers and schedules
Expired option records
Payroll records and summaries, including payments to pensioners
Plant cost ledgers
Purchasing department copies of purchase orders
Sales records
Cancelled stock and bond certificates
Subsidiary ledgers
Time books
Voucher register and schedules
Voucher for payments to vendors, employees, etc.

One Year Retention

Bank reconciliations
Correspondence with customers or vendors
Duplicate deposit slips
Purchase orders (except purchasing department copies)
Receiving sheets
Requisitions
Stenographer's notebooks
Stockroom withdrawal forms

9.600 AUTOMOBILE FRINGE BENEFITS

Demonstrator Vehicles

9.601 Qualified automobile demonstration use is treated as a "working condition fringe benefit" provided the restrictions under IRC Section 132 and the related IRC Regulations are met. "Qualified demonstration use" means any use of an automobile by a "full-time automobile salesperson" in the dealer's sales office if (a) the use is provided primarily to facilitate the salesperson's performance of services for the employer and (b) there are substantial restrictions on the salesperson's personal use of the automobile. The fair market value of any use by a full-time salesperson of a qualified demonstration automobile in the dealer's geographic sales area is excluded from the employee's income.

9.602 A "demonstration automobile" is an automobile that is (a) currently in the dealership's inventory and (b) available for test drives during the dealership's normal business hours.[85]

9.603 A "full-time automobile salesperson" is defined as any individual who:[86]

- is employed by the dealer
- customarily spends at least one-half of a normal business day substantially performing the functions of a floor salesperson or sales manager
- directly engages in substantial promotion and negotiation of sales to customers
- customarily works the number of hours considered full-time in the industry, which is at least 1,000 hours annually
- derives at least 25 percent of his or her gross income from the dealership as a direct result of the above activities

9.604 All personal use of a demonstration automobile by an individual other than a "full-time automobile salesperson" is not "qualified demonstration use" and is not considered a working condition fringe benefit. Restrictions on personal use include use, including commuting, of a demonstration automobile by a part-time salesperson, automobile mechanic, bookkeeper or clerical assistant, non-sales manager, or other individual not functioning in a sales capacity. The fair market value of personal use of demonstration automobiles must be included in the individual's income. Dealers must substantiate the business use of the demonstrator, otherwise upon audit the IRS will claim all use was personal. The value of personal use to be included in the employee's income is determined from the Annual Lease Value Table, reproduced shown in Illustration No. 9-2.[87]

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[85] IRC Regulation Section 1.132-5(o)(3)(i).

[86] IRC Regulation Section 1.132-5(o)(2)(i).

[87] IRC Regulation Section 1.61-21(d)(2)(iii).

ILLUSTRATION NO. 9-2

ANNUAL LEASE VALUE TABLE

Automobile fair market value	Annual Lease Value
$0 to 999	$ 600
1,000 to 1,999	850
2,000 to 2,999	1,100
3,000 to 3,999	1,350
4,000 to 4,999	1,600
5,000 to 5,999	1,850
6,000 to 6,999	2,100
7,000 to 7,999	2,350
8,000 to 8,999	2,600
9,000 to 9,999	2,850
10,000 to 10,999	3,100
11,000 to 11,999	3,350
12,000 to 12,999	3,600
13,000 to 13,999	3,850
14,000 to 14,999	4,100
15,000 to 15,999	4,350
16,000 to 16,999	4,600
17,000 to 17,999	4,850
18,000 to 18,999	5,100
19,000 to 19,999	5,350
20,000 to 20,999	5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
46,000 to 47,999	12,250
48,000 to 49,999	12,750
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250
Over 59,999	.500 + (.25 × fair market value of vehicle)

9.605 The dealer must place substantial restrictions on the personal use of demonstration automobiles for such use to qualify as a working condition fringe benefit. These restrictions require that the dealership:[88]

- prohibit use of a demonstration automobile by individuals other than full-time salesperson
- prohibit use of demonstration automobiles for personal trips
- prohibit the storage of personal possessions in demonstration automobiles
- limit, by mileage, a "full-time automobile salesperson's" use of demonstration automobiles outside the person's normal working hours

9.606 The sales area in which use of a demonstration automobile qualifies as a working condition fringe benefit is limited to the surrounding geographic sales area from which the dealer regularly derives customers. This sales area "safe harbor" may be treated as the larger of the area within a 75-mile radius of the dealer's sales office or the one-way commuting distance of the particular salesperson.[89]

9.607 Notwithstanding any of the above, the fair market value of the use of a demonstration automobile may not be excluded from gross income as a "working condition fringe benefit" by either the employee or the employer, unless the substantiating documentation requirements of IRC Section 274(d) and the regulations thereunder are satisfied.[90]

9.608 Under LIFO inventory methods, no deduction for depreciation or write-down in value attributable to use of demonstration vehicles is allowed.

Employer-Provided Fringe Benefits

9.609 A principal employer-provided fringe benefit for a dealership's employees is an employer-provided automobile. The value of the benefit to the employee is based on the fair market value of the automobile, which is the amount an individual would pay for the automobile in an arm's-length transaction, including sales tax, title fees, and the purchase price of the automobile, including options and accessories. For automobiles owned by the employer, the value of the automobile for basing fringe benefit computations is the employer's cost of the automobile, provided the purchase is made at arm's-length. For automobiles leased by the employer, the value of the automobile for basing fringe benefit computations is either the manufacturer's suggested retail price of the automobile less eight percent or the value as determined based on nationally recognized pricing sources.[91]

9.610 The value of the annual benefit to be included in the employee's income is determined from the Annual Lease Value Table shown in Illustration No. 9-2.[92]

- If the automobile is available to the employee for the entire year, the amount included in income is the Annual Lease Value Table amount corresponding to the fair market value of the automobile, as determined above.

[88] IRC Regulation Section 1.132-5(o)(4).

[89] IRC Regulation Section 1.132-5(o)(5).

[90] IRC Regulation Section 1.132-5(o)(6).

[91] IRC Regulation Section 1.61-21(d)(5)(ii).

[92] IRC Regulation Section 1.61-21(d)(2)(iii).

- If the automobile is used less than a full year, but more than 30 days, the annual amount is prorated by multiplying the applicable Annual Lease Value by the number of days of availability over 365 days.[93]
- If the automobile is used less than 30 days, the amount included in income is based on the Daily Lease Value. The Daily Lease Value is calculated by multiplying the applicable Annual Lease Value by four times the number of days of availability over 365 days.[94]

9.611 Dealers who maintain a fleet of 20 or more vehicles for employee use may use the average cost of fleet vehicles (fleet-average value) for purposes of calculating the Annual Lease Values. The Annual Lease Value, based on the fleet-average value, remains in effect for the period that begins on the first January 1 the fleet-average valuation rule is applied and ends on December 31 of the subsequent calendar year. If the number of qualifying automobiles in the dealer's fleet declines to fewer than 20 for more than 50 percent of the days in a year, the fleet-average valuation rules do not apply and the Annual Lease Value must be determined separately for each remaining automobile.[95]

- The fleet-average rule may not be used for any automobile with a fair market value as of the date on which the automobile is made available to the employee for personal use, or, if later, January 1, of more than $16,500.
- An employee may only use the fleet-average rule if it is used by the employer.

9.612 Dealers providing employees with vehicles are required to retain records to substantiate the amount of expense deductible as business use of the vehicle. The employee includes in income only the personal use portion of the Annual Lease Value Table amount for automobiles with both business and personal use. The employee is required to keep separate records substantiating the business use of the automobile. These records include mileage logs and other expense receipts identifying the dates, times, places and business purposes of the vehicle use. However, if the dealer maintains a written policy statement under either of the following two safe harbors, the employee is relieved of keeping separate records.

9.613 Under the first safe harbor, the dealer must establish and maintain a written policy statement that ***prohibits personal use (including commuting)*** and that meets the following conditions:[96]

- The vehicle is owned or leased by the dealer and is provided to one or more employees for use in the dealer's business.
- When the vehicle is not used in the dealer's business, it is kept on the dealer's premises, unless temporarily located elsewhere, for example, for maintenance.
- No employee using the vehicle may live at the dealer's premises.
- No employee may use the vehicle for personal purposes, other than de minimis personal use (such as a stop for lunch between two business deliveries).
- Except for de minimis use, the dealer reasonably believes that no employee uses the vehicle for any personal purpose.

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[93] IRC Regulation Section 1.61-21(d)(4)(i)(A).

[94] IRC Regulation Section 1.61-21(d)(4)(ii).

[95] IRC Regulation Section 1.61-21(d)(5)(v).

[96] IRC Regulation Sections 1.132-5(e) and 1.274-6T.

9.614 Under the second safe harbor, the dealer must establish and maintain a written policy statement prohibiting personal use ***except for commuting***. This safe harbor is not available for a commuting employee who is an officer, director, or a 1 percent or more owner of the dealership. Under this second safe harbor, the following conditions must be met:[97]

- The vehicle is owned or leased by the dealer and is provided to one or more employees for use in the dealer's business and is used in the dealer's business.
- For bona fide noncompensatory business reasons, the dealer requires the employee to commute to and/or from work in the vehicle.
- The dealer establishes a written policy under which the employee may not use the vehicle for personal purposes, other than commuting or de minimis personal use (such as a stop for a personal errand between a business delivery and the employee's home).
- Except for de minimis use, the dealer reasonably believes that the employee does not use the vehicle for any personal purpose other than commuting.
- The dealer accounts for the commuting use by including an appropriate amount in the employee's gross income.

9.700 EXCISE TAXES

Luxury Vehicle Excise Tax

9.701 IRC Section 4001 imposes an excise tax on the first retail sale of any passenger vehicle equal to 10 percent of the excess of the sales price over $30,000. Moreover, IRC Section 4004(b) imposes the 10 percent excise tax on separate purchases of parts and accessories to the extent their addition causes the total purchase price of the original vehicle, including previously added parts and accessories, to exceed $30,000. An exception to the separate purchase rule is provided for replacement parts or accessories and a de minimis exception if the taxable part or accessory does not exceed $200.

9.702 OBRA '93 provides for indexation of the $30,000 threshold by $2,000 increments, as adjusted downward.[98] The new threshold for any year will be computed by increasing $30,000 by the cumulative inflation since 1990 with the result rounded down to the nearest $2,000 increment. The $32,000 threshold is effective January 1, 1994, and remains effective through 1995.

9.703 The dealer making the first retail sale is responsible for the collection and payment of the luxury excise tax.[99]

9.704 An exemption is provided on sales of luxury automobiles for use by the purchaser exclusively in the active conduct of a trade or business of transporting persons or property for compensation or hire, such as taxicabs or limousines. The dealer must obtain an exemption certificate from the purchaser prior to or at the time of the transaction. The certificate need not take any special form and need not be a separate document. However, it must be in writing and signed by the purchaser.[100]

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[97] IRC Regulation Sections 1.132-5(f) and 1.274-6T.

[98] OBRA '93 Section 13161.

[99] IRC Regulation Section 48.4011-3.

[100] IRC Section 4221(c).

9.705 The sale price of the vehicle is the total consideration paid for the vehicle regardless of whether payment is in currency, services, or property, such as a trade-in vehicle. The sale price includes transportation, delivery, insurance, packaging, preparation, installation, and other expenses incurred by the purchaser in conjunction with putting the car in service. The price of parts and accessories added at time of sale is also included. The sale price subject to tax does not include: the amount of the luxury tax imposed; separately stated retail sales taxes imposed by states or their political subdivisions; separately stated charges for title, registration, or license fee imposed by states or their political subdivisions; separately stated costs of insurance or extended warranty contracts the purchaser is not required to purchase; and the amount of any rebate or price adjustment paid to the purchaser of the vehicle.[101]

9.706 An IRS National Office Technical Advice Memorandum due to be released concludes that lease acquisition fees charged customers is not to be included as part of the vehicle's sales price for purposes of computing the luxury excise tax. The vehicle lease price negotiated between dealer and customer is acceptable evidence of the lowest price for which the vehicle would be sold by a retailer pursuant to IRC Section 4002(c)(2)(C)(i).

9.707 Prior to OBRA '93, an exception was provided for 200 miles of non-taxable vehicle use, as well as for usage as a demonstrator vehicle, provided the customer was in the vehicle during that use. If the total vehicle use exceeded 200 miles, the dealer had to prove through mileage logs, or otherwise, that the excess mileage was attributable to non-taxable uses, such as test drives, to avoid having to pay the luxury use tax before the vehicle was sold.[102] OBRA '93 removed these restrictions on demonstrator use for purposes of the luxury tax. However, the IRS has not addressed the need for revised regulations regarding demonstrator vehicles. Discussions with the IRS have indicated that the dealer's current definition of demonstrator use should suffice for purposes of complying with the luxury auto tax requirements.

9.708 The luxury tax is computed using Form 8807, *Certain Manufacturers and Retailers Excise Taxes*. IRS Abstract No. 92 provides specific instructions. Taxpayers are required to report tax liability using Form 720, *Quarterly Excise Tax Return*. For luxury auto excise taxes, quarterly tax returns are due on April 30, July 31, October 31 and January 31 for the first through fourth calendar quarters, respectively. Form 8807 should be attached to Form 720 when filed.

9.709 Tax deposits for luxury auto taxes are subject to the IRS nine-day rule. Tax deposits are made using Form 8109, *Federal Tax Deposit Coupon*, at an authorized depositary or the Federal Reserve bank serving the taxpayer's local area. Deposits are due semimonthly, nine days after the end of the semimonthly period. For example, a tax liability incurred between January 1 and 15 must be deposited by January 24, and a tax liability incurred between January 16 and 31 must be deposited by February 9.

9.710 Form 8807, *Certain Manufacturers and Retailers Excise Taxes* and Form 720, *Quarterly Federal Excise Tax Return* are provided in sections 9.906 and 9.907, respectively.

Ozone Depleting Chemical Tax

9.711 The Omnibus Budget Reconciliation Act of 1989 enacted legislation for an excise tax on chemicals that deplete the ozone layer and on products containing those chemicals. The tax was effective January 1, 1990.[103]

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[101] See IRC Regulation Section 48.4011-4 for the definition of "sales price".

[102] IRC Section 4011(b)(3) and IRC Regulations Section 48.4011-5.

[103] Treasury Decision (T.D.) 8311, 1990-2 CB 223 and IRC Regulation Section 52.4681-1(d)(1).

9.712 IRC Section 4681 imposes a tax on an ozone depleting chemical (ODC) when the ODC is sold or used by its manufacturer or importer. This Section also imposes a tax on imported products containing or manufactured with ODCs when the product is sold or used by its importer. IRC Section 4682(h) imposes a floor stocks tax on ODCs that are held for sale or for use in further manufacture on January 1, 1990, 1991, 1992, 1993, or 1994 by any person other than the manufacturer or importer of the ODC.

9.713 ODCs subject to tax and their individual tax rates are identified in IRS Abstract No. 98.[104] The tax on imported products is based on the weight of the ODCs used in the product, if known, or 1 percent of the import entry value if the ODC weight is unknown. Generally, the imported taxable product is taxed at the time it is sold or used by the importer. However, the importer may elect to pay the tax when the product enters the United States.

9.714 Tax is computed using Form 6627, *Environmental Taxes*. Taxpayers are required to report their tax liability using Form 720, *Quarterly Excise Tax Return*, which are due on May 31, August 31, November 30 and February 28 for the first through fourth calendar quarters, respectively. Form 6627 should be attached to the Form 720 when filed. The filing date for the floor stocks tax on ODCs is August 31.

9.715 Tax deposits for ODC taxes are subject to the IRS 30-day rule. Tax deposits are made using Form 8109, *Federal Tax Deposit Coupon*, at an authorized depositary or the Federal Reserve bank serving the taxpayer's local area. Deposits are due semimonthly on the last day of the second following semimonthly period. For example, a tax liability incurred between the January 1 and 15 is due by February 15, and a tax liability incurred between January 16 and 31 is due by February 28.

9.716 Form 6627, *Environmental Taxes* is shown in section 9.908.

9.800 IRS AUDIT PREPARATION

9.801 The automobile dealer industry is one of the industries for which the IRS has developed special industry expertise to assist its field agents in conducting audits. As a result, many of the topics discussed previously in this Chapter are emphasized by field agents in the course of their audits. A dealer's best preparation for an IRS audit is to understand the tax issues to which the IRS is sensitive. With a thorough understanding of those issues, the dealership can implement reporting and control systems within its operation to ensure compliance with the tax laws before receiving any notice of a pending audit.

9.802 Section 9.909 reproduces the IRS auto dealer's handbook section of the Internal Revenue Manual, which the IRS distributes to its field personnel. The remainder of this section discusses those audit issues that revenue agents generally focus on during an audit.

9.803 In general, dealers in new automobiles are required to use the accounting systems prescribed by the automobile manufacturers. This results in considerable uniformity of systems among dealers throughout the United States, and an excellent opportunity for IRS agents to become intimately familiar with the systems. Also, dealers in new automobiles are required to submit financial reports to the manufacturer periodically and these reports can easily be reconciled to the dealer's federal income tax return to identify discrepancies in income, expenses and inventories. Accounts under the headings

[104] IRC Regulation Section 52.4681-1(c)(9).

"Additions to Income" and "Deductions from Income" on the federal income tax return cover transactions other than the day-to-day business and are likely to be examined closely by the agent.

9.804 Because inventories are a material income-producing factor, dealers throughout the United States are required to compute gross profit on an accrual basis. The problems in determining gross profits to be reported on the dealer's tax return are reasonably standard throughout the U.S.

9.805 Dealer sales records are likely to be examined and correlated with other financial data by the IRS agent to detect possible underreporting of sales. Any inconsistencies detected are likely to lead to a more detailed examination of sales records. The following are examples of the data likely to be correlated with sales records.

- Financial statements submitted to the automobile manufacturer
- Freight charges incurred for automobiles purchased
- Sales tax payments
- Deposits made by customers for future purchases
- Financing of customer installment obligations and the dealer reserve holdback accounts
- Comparison of used car sales prices with market quotations obtained from the NADA Black Book
- Delivery cost preparation charges compared to factory reimbursements

9.806 Dealer reserve holdback accounts are examined to ensure that commissions paid by finance companies are properly included in income as they are accrued. Deferred income accounts in the dealer's books may suggest to the IRS agent that income is not being properly reported for federal income tax purposes. A reconciliation of monthly statements from the finance companies can confirm that income has or has not been properly reported.

9.807 As discussed in sections 9.417–9.428, dealers often establish their own finance departments, whereby they can accrue finance charges ratably over the period of the contract rather than recognizing the total amount at the time the sales contract is executed. As a result, the dealer's accounting system must clearly distinguish internally financed sales from customer installment notes sold at a discount to finance companies to ensure proper recognition of income.

9.808 Revenue agents also analyze customer deposit accounts to determine whether any large amounts recorded in the last month of the year should be recognized as sales. Dealer's practice of issuing contingent credit memoranda for customer deposits is likely to be examined closely to determine if advance payments relating to automobile sales are reported in income correctly.

9.809 Dealers may receive manufacturer rebates, discounts, bonuses and holdbacks as sales incentives on old models after the model year change, for meeting or exceeding sales quotas, for reimbursement of advertising expenses, or for reimbursement of parts used in warranty adjustments. Manufacturer holdbacks for these items may be paid to dealers after the end of the year in which they are accrued. Arrangements with the manufacturer are likely to be examined to insure that income is included in the year earned.

9.810 Dealers receiving insurance commissions from their captive insurance agencies can expect the income to be reconciled from monthly commission statements to recorded income. The insurance broker-auto dealer relationship is likely to be examined to determine if a related corporation is receiving the insurance commissions or if the officers of the dealership are receiving insurance commissions personally and not reporting the income in the dealership's books. In these situations, the relationship will be analyzed to determine if the pricing was done in an "arms-length" transaction or if the officers received constructive dividends from the dealership.

9.811 The IRS examines inventory accounts of new automobiles to determine that inventories are valued correctly and that the cost of dealer-installed accessories are included. Vehicle records are examined to determine if there is personal use involved or if personal use vehicles are removed from the books and later repurchased by the dealership. Used car inventory records are examined to determine if trade-ins and purchases are properly valued and reconditioning costs are properly charged to the inventory account. New vehicle sales contracts are examined to confirm that trade-ins are recorded into inventory and subsequent sales are recorded. Inventory valuation reserve accounts are investigated to determine if arbitrary reductions or write-downs in inventories are being taken. Parts inventory accounts are examined to determine if arbitrary write-downs of parts for prior years' models have been taken.

9.812 The IRS aggressively reviews dealership's policies and practices regarding demonstrator vehicles. Records of demonstrator vehicles are examined to substantiate that only qualified personnel have been assigned demonstrators and that personal use is accounted for properly. Lists of personnel assigned demonstrator vehicles may be checked against payroll records to detect family members and others who do not qualify for demonstrator vehicles. Individuals not qualifying for demonstrator vehicles would have to report additional income attributable to their personal use of company vehicles. Depreciation expense accounts are reconciled to verify that depreciation is not taken on demonstrator vehicles.

9.813 Repossessions of automobiles should be valued at the lower of the purchase price plus repossession expenses or the appraised wholesale value less estimated reconditioning expenses. Dealers can expect the IRS to review the computation of gain or loss from repossessions.

9.814 Postings to a "car discount" account from sources other than a car discount sales journal may indicate to the IRS agent that discounts are actually unrecorded trade-ins (with the proceeds from subsequent sales not recorded in income), or that cash disbursements from the discount account represent improper payments to third parties.

9.815 For tax years beginning after December 31, 1986, the bad debt reserve method was repealed for dealers. Dealers must use the specific charge-off method in accounting for losses on bad debts. When installment notes held by the finance company become worthless, they are charged to the dealer's reserve or directly to the dealer. The loss from the worthless note represents a bad debt to the dealer. However, the dealership must still prove the account is uncollectible and therefore worthless before the bad debt can be written off.

9.816 The revenue agent may reconcile salesmen's commission accounts with actual sales and commission agreements to determine if income is reported properly. Total commissions are likely to be reconciled to W-2 Forms.

9.817 Arrangements for the leasing and rental of dealership facilities from corporate shareholders are examined to determine if the arrangements represent "arm's-length" transactions between the related parties. Fair rental values of comparable properties in the dealer's area may be used to substantiate transactions not at arm's-length. Moreover, differences between the fair rental value and the amount actually paid can be construed by the IRS as constructive dividends to the shareholders.

9.850 STATE TAXATION

9.851 This section presents certain state taxation issues that are of general concern to auto dealers doing business within one state, as well as dealerships with operations that cross state boundaries. (A detailed presentation of state taxation issues on a state-by-state basis is beyond the scope of this Chapter.) The issues presented in this section are:

- Nexus — establishing a business presence
- Choice of business entity
- Income taxation methods
- Other taxes

Nexus

9.852 Nexus refers to the state's ability to exert legal jurisdiction over a dealership. This ability is obvious for dealerships that are resident of a particular state. States require corporations and other business entities to register annually and pay franchise fees to be able to do business within the state and to be able to seek redress within the state's courts. Historically, nonresident auto dealers must have had either property or employees located in the state or must have been incorporated in the state for that state to have had legal jurisdiction over the nonresident auto dealer.

9.853 Nexus, in a tax context, refers to a certain level of contact between the state and a dealership sufficient to subject the dealership to the state's taxing jurisdiction. The definition of nexus varies from state to state and depends on the facts and circumstances, rather than the application of precise standards. However, the same general considerations that govern the state's ability to regulate commerce also apply to determining the state's ability to exert its taxing jurisdiction. A state's interpretation of nexus is valid provided it does not violate either the Commerce Clause or the Due Process Clause of the U.S. Constitution.

9.854 Dealerships with operations likely to cross state boundaries may be able to avoid the nexus issues by establishing separate entities in those states and limiting operations to intrastate transactions, thereby minimizing the complexities of state taxation issues.

Choice of Business Entity

9.855 When making a choice of business entity, auto dealers must evaluate the state tax provisions for the different types of entity. States do not automatically follow the federal income tax provisions for entities doing business within the state.

9.856 Subchapter S Corporations, which are pass-through entities for federal income tax purposes, may be treated at the state level as subchapter C corporations subject to state income taxes. Moreover, states may require the dealership to elect S corporation status at the state level. Other states recognize the federal S election for state tax purposes.

9.857 The ability of an S corporation to be treated as a C corporation for state tax purposes may be advantageous if corporate state tax rates are lower than individual state tax rates. State income taxes are deductible by corporations for federal income tax purposes, whereas individual S corporation shareholders may receive little benefit on their federal tax return from a deduction for state income taxes paid personally.

9.858 Nonresident S corporation shareholders are likely to be subject to state personal income taxes on their distributive share of the corporation's income and will be required to file state tax returns and pay state income tax as nonresident individuals.

9.859 Limited Liability Companies, which may be treated as partnerships for federal income tax purposes, may be treated as corporations for state income tax purposes. Florida, for example, treats LLCs as if they were subchapter C corporations subject to the state income tax. Florida S Corporations, however, are not subject to state income taxes.

Income Taxation Methods

9.860 Generally, federal taxable income is the starting point for determining state taxable income. States may have their own special deductions and credits, special rules for computing depreciation, as well as different rules for applying net operating losses and computing alternative minimum taxes. State income tax typically is computed using one of three methods:

- Apportionment factor based on factors computed for property, payroll and sales
- Separate accounting
- Unitary method of taxation

9.861 Apportionment Factor. The apportionment factor approach is based on computation of separate factors for property, payroll, and sales, which provide the basis for apportioning taxable income to the state. Generally, an average of the individually computed factors is used to apportion taxable income. However, some states give additional weight to the sales factor.

- **Property Factor.** The property factor is the ratio of the average value of the dealership's realty and tangible personal property owned or rented and used in the state in the regular course of business during the tax period to the total value of such property owned or rented and used everywhere.

  Real and tangible property includes land, buildings, machinery, inventory, equipment and other realty or tangible property. Property under construction during the tax period is excluded until actually used.

  Generally, rented property is valued at a multiple of the annual rent to establish parity with the value of owned property.

- **Payroll Factor.** The payroll factor is the ratio of the total amount the dealership paid during the tax period for compensation in the state to the total compensation paid everywhere.

  Compensation includes wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. Amounts considered compensation include deferred compensation, the value of rent, housing, lodging, and other benefits or services furnished to employees by the dealership for personal services provided these amounts constitute income to the recipient for federal income tax purposes.

- **Sales Factor.** The sales factor is the ratio of dealership sales within the state *during* the tax period to total dealership sales everywhere during the tax period.

  Sales includes all gross receipts received by the dealership from transactions and activities in the regular course of business. Generally, special rules apply to nonbusiness income, such as interest, dividends, rents, royalties and gains and losses from the sale of securities, to determine if income of these types are included in dealership sales.

9.862 Separate Accounting. The apportionment factor approach may result in the computation of a taxable income that does not fairly reflect business operations within the state. Under these circumstances, certain states provide for a separate accounting method to determine the state's taxable income. Separate accounting in effect requires maintaining a separate set of books and records reflecting only those items of income and expense that pertain to operations within the state. Taxable income, as computed under separate accounting, would likely result in a lower tax than under the apportionment approach. Otherwise, there would be little advantage to using this method.

9.863 Unitary Method. The unitary method of taxation computes tax at the state's tax rates for the dealership's worldwide income. The tax computed is then pro-rated based on the ratio of income attributable to the state to total worldwide income. California is the most notable example of a state that uses the unitary method of taxation.

Other Taxes

9.864 Dealerships are subject to a variety of other state and local taxes, including:

- **Sales and Use Taxes.** State sales taxes apply to the sales of tangible property to customers. Use taxes apply to materials used by the dealership, not for resale to customers, for which sales tax was not paid by the dealership at the time the materials were acquired.

- **Intangible Property Taxes** on the value of dealership intangible property, such as accounts receivable, finance contracts receivable, and other marketable securities.

- **Excise Taxes** on the use and disposal of hazardous waste materials.

- **Tangible Property Taxes** on the value of tangible personal property, such as machinery and equipment, used by the dealership in the normal course of business.

- **Real Estate Property Taxes** based on the value of real property, land, and building, owned by the dealership.

9.890 REFERENCE SOURCES

9.891 Included as exhibit 9.910 is a listing of tax court cases, IRS announcements, Treasury Decisions, revenue rulings, revenue procedures and private letter rulings which directly and indirectly pertain to tax issues affecting auto dealerships.

9.900 EXHIBITS

Section	Description
9.901	Asset Acquisition Statement Under Section 1060 (Form 8594)
9.902	Alternative LIFO Method (Rev. Proc. 92-79) — Sample Computations and Explanations
9.903	Sample Application to use LIFO Inventory Method (Form 970)
9.904	Sample Application for Change in Accounting Method (Form 3115)
9.905	Report of Cash Payments Over $10,000 Received in a Trade or Business (Form 8300)
9.906	Certain Manufacturers and Retailers Excise Taxes (Form 8807)
9.907	Quarterly Federal Excise Tax Return (Form 720)
9.908	Environmental Taxes (Form 6627)
9.909	Auto Dealer's Handbook Section of the Internal Revenue Manual
9.910	Reference Sources

Form **8594**
(Rev. January 1993)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060

▶ Attach to your Federal income tax return.

OMB No. 1545-1021
Expires 2-29-96

Attachment
Sequence No. 61

Name as shown on return | Identification number as shown on return

Check the box that identifies you: ☐ Buyer ☐ Seller

Part I General Information - To be completed by all filers

1 Name of other party to the transaction | Other party's identification number

Address (number, street, and room or suite no.)

City, state, and ZIP code

2 Date of sale | 3 Total sales price

Part II Assets Transferred - To be completed by all filers of an original statement

4 Assets	Aggregate Fair Market Value (Actual Amount for Class I)	Allocation of Sales Price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV		$
Total		$

5 Did the buyer and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . . ☐ Yes ☐ No

If "Yes," are the aggregate fair market values listed for each of asset Classes I, II, and III the amounts agreed upon in your sales contract or in a separate written document? . . . . . ☐ Yes ☐ No

6 In connection with the purchase of the group of assets, did the buyer also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . ☐ Yes ☐ No

If "Yes," specify (a) the type of agreement, and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See the instructions for line 6.

For Paperwork Reduction Act Notice, see instructions. Form **8594** (Rev. 1-93)

Exhibit 9.901

Part III Class III, Intangible Amortizable Assets Only - Complete if applicable. The amounts shown below also must be included under Class III assets in Part II. Attach additional sheets if more space is needed.

Assets	Fair Market Value	Useful Life	Allocation of Sales Price
	$		$
	$		$
	$		$
	$		$
	$		$
	$		$
	$		$
	$		$
	$		$

Part IV Supplemental Statement - To be completed only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration.

7 Assets	Allocation of Sales Price as Previously Reported	Increase or (Decrease)	Redetermined Allocation of Sales Price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Total	$		$

8 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

9 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

ALTERNATIVE LIFO METHOD (REV. PROC. 92-79)

Sample Computations and Explanations

	1	2	3	4	5	6
Item Category Summary	Actual Ending Inventory		Ending Inventory at Beginning-of-Year Prices (A)		Ending Inventory at End-of-Year Prices (B)	
	# of Units	Value	Per Unit	Extended	Per Unit	Extended
AAA	25	914,000	30,000	750,000	32,000	800,000
BBB	14	280,000	17,867	250,138	19,000	266,000
CCC	25	690,200	24,500	812,500	26,796	669,900
FFF - New Model Code (New Item)	1	8,996 (D)	8,402	8,402	8,402	8,402
DDD - Not in Pior Year Inventory	2	24,465 (E)	9,550	19,100	10,248	20,496
EEE - 93 Model	17	236,528	10,973	186,541 (F)	11,899	202,283
EEE - 92 Model	3	45,811	10,973	32,619	10,793	32,919
Total for Pool (G)	87	2,200,000		1,859,600		2,000,000
Current Year Index	Ending Inventory @ End-of-Year Prices / Ending Inventory @ Beginning-of-Year Prices			2,000,000 / 1,859,600		1.0755 (C)

(A) For models which do not have MODEL CODE OR PLATFORM CHANGES, this is the average base price at the beginning of the year (computed at end of prior year) UNADJUSTED for any optional to standard equipment changes, other equipment enhancements, options and accessories or destination charges.

(B) Same as (A), except this column reflects the END of year unadjusted base prices.

(C) The Index of 1.0755 for the year is then multiplied by the prior year cumulative index to arrive at the current year cumulative index. The current year cumulative index is then applied to the entire actual ending inventory cost of $2,200,000 to deflate it to the base price. As the prior cumulative index for this first year is 1.00 (see Sec. 9.02(8) of Rev Proc 92-79), the current year cumulative is 1.0755. This number applied to the entire actual inventory of $2,200,000 deflates it to $2,045,560. This is the ending inventory in base year dollars.

(D) This is the same base price as the end of the year base price. Note that it results in no inflation for that item entering into the end-of-year columns.

(E) For an item in existance in the prior year, but not on hand at the end of the prior year, repricing reference may be made to the manufacturer's price list that provides dealer purchase prices. For each such item category, use the manufacturer's price list in effect as of the beginnning of the last month of the prior taxable year.

(F) In computing the average base vehicle cost for each item category in accorance with Step 4, the average price to be used in the following year for item category EEE wil be $11,760 ((202,283 / 32,919) divided by (17 / 3)). (235,202 / 20) = $11,760.

(G) POOLS: Item categories are combined into pools. Under the Alternative Lifo Method, ther must be two (2) pools: Pool #1 for all new autos (including demos) and Pool #2 for all new light-duty trucks including demos.

ALTERNATIVE LIFO METHOD (REV. PROC. 92–79)

SAMPLE LIFO WORKPAPER
to be used in connection with Alternative LIFO workpaper

		Year of Change
	1991	1992
Beginning of year inventory @ base	1,200,000	1,622,178
End of year inventory at current prices	1,622,178	2,200,000
End of year inventory at beginning (base) prices	N/A	1,859,600
Inventory at ending (base) prices	N/A	2,000,000
Current year price index	1.0600	1.0755
Prior year cumulative index	1.1772	1.0000
Current year cumulative	1.2478	1.0755
End of year inventory @ base date cost	1,299,997	2,045,560
Current year increase(decrease)	99,997	423,382
Lifo valuation of increment	124,780	455,347

Analysis of Lifo Layers		Base	Index	Lifo	Base	Index	Lifo
	1988	400,000	1.0000	400,000	499,133	0.8014	400,000
	1989	200,000	1.0900	218,000	249,566	0.8735	218,000
	1990	600,000	1.1772	706,320	748,699	0.9434	706,320
	1991	100,000	1.2478	124,780	124,780	1.0000	124,780
	1992				423,382	1.0755	455,347
	Totals	1,300,000		1,449,100	2,045,560		1,904,447
Less ending inventory at current year prices				1,622,178			2,200,000
End of year lifo reserve				173,078			295,553
Prior year lifo reserve				101,078			173,078
Increase (decrease) to reserve				72,000			122,475

Exhibit 9.902

ALTERNATIVE LIFO METHOD (REV. PROC. 92–79)

EXAMPLE OF REBASING UNDER REV. PROC. 92–79 SECTION 9.02(8)

BEFORE

Year	Base Cost	Index	LIFO Value
1988	400,000	1.0000	400,000
1989	200,000	1.0900	218,000
1990	600,000	1.1772	706,320
1991	100,000	1.2478	124,780
	1,300,000		1,449,100

AFTER

Year	Base Cost	Index	LIFO Value
1988	499,133	0.8014	400,000
1989	249,566	0.8735	218,000
1990	748,699	0.9434	706,320
1991	124,780	1.0000	124,780
	1,622,178		1,449,100

ALTERNATIVE LIFO METHOD (REV. PROC. 92–79)

EXAMPLE OF COMBINING POOLS

Chevy Pool

Year	Base Cost	Index	LIFO Value
1988	400,000	1.0000	400,000
1989	200,000	1.0900	218,000
1990	600,000	1.1772	706,320
1991	100,000	1.2478	124,780
	1,300,000		1,449,100

Buick Pool

Year	Base Cost	Index	LIFO Value
1987	300,000	1.0000	300,000
1990	700,000	1.3000	910,000
1991	100,000	1.3780	137,800
	1,100,000		1,347,800

Combined Pool

Year	Base Cost	Index	LIFO Value
1987	300,000	1.0000	300,000
1988	380,000	1.0526	400,000
1989	190,000	1.1474	218,000
1990	1,270,000	1.2727	1,616,320
1991	195,000	1.3466	262,580
	2,335,000		2,796,900

Form **970** (Rev. November 1992) Department of the Treasury Internal Revenue Service

Application To Use LIFO Inventory Method

▶ Attach to your tax return.

▶ For Paperwork Reduction Act Notice, see Instructions on back.

OMB No. 1545-0042 Expires 10-31-95

Name	Identifying number (See instructions)
Number, street, and room or suite no. (If a P.O. box, see instructions.)	CHECK ONE: ☐ First Election ☐ Subsequent Election
City or town, state, and ZIP code	

Part I Statement of Election

		Yes	No
A	The taxpayer elects to adopt and use the LIFO inventory method provided by section 472. The taxpayer will use (or expand) the LIFO inventory method for the first tax year ending (month, day, year) ▶ .... for the following goods (see instructions): NEW AUTOMOBILES & NEW LIGHT-DUTY TRUCKS		
	* THE TAXPAYER ELECTS TO USE THE ALTERNATE LIFO METHOD PROVIDED IN REV PROC 92-79.		
B	The taxpayer agrees as required by Regulations section 1.472-4, to make any adjustments that the District Director of Internal Revenue may require, on the examination of the taxpayer's income tax return, to clearly reflect income for the years involved in the change to or from the LIFO inventory method or due to the use of the LIFO inventory method.		
C	Was the beginning inventory for the items specified in Item A above, valued at cost (as required by section 472(d)) for the first tax year this application applies? If "No," attach an explanation	✓	
D	Will inventory be taken at actual cost regardless of market value? If "No," attach an explanation	✓	

Part II Other Information

		Yes	No
1	Nature of business ▶ AUTOMOBILE DEALERSHIP - SALES & SERVICE		
2	Inventory method used until now ▶ SPECIFIC IDENTIFICATION		
3	Will any adjustment that resulted from the change to the LIFO method be included in income over a 3-year period? If "No," attach an explanation	✓	
4a	List goods subject to inventory that will not be inventoried under the LIFO method ▶		
b	Were the goods specified in Item A, above, treated as acquired at the same time and at a unit cost equal to the actual cost of the total divided by the number of goods on hand? If "No," attach explanation	✓	
5a	Did you issue credit statements or reports to shareholders, partners, other proprietors, or beneficiaries covering the first tax year to which this application relates?	✓	
b	If "Yes," state to whom and on what dates ▶		
c	Show the inventory method used to determine income, profit, or loss in those statements ▶ LIFO		

6a Check method used to figure the cost of the goods in the closing inventory over those in the opening inventory. (See instructions.)
☐ Most recent purchases ☐ Earliest acquisitions during the year
☐ Average cost of purchases during the year ☒ Other—Attach explanation SPECIFIC IDENTIFICATION

6b The taxpayer selects the month of .... as the representative month used in selecting the index or indexes used to determine the current-year cost of the taxpayer's inventory pool(s) under Regulations section 1.472-8(e)(2)(ii) (see instructions). **This applies only to taxpayers using the Inventory Price Index Computation Method.** N/A

7 Method used in valuing LIFO inventories: ☐ Unit method ☒ Dollar-value method

8 If you use pools, check the box that indicates the pooling method. List and describe the contents of each pool in an attached statement.
☒ By line, type, or class of goods authorized by Regulations section 1.472-8(c) (retailer, wholesaler, jobber, or distributor)
☐ Pooling method authorized by Regulations section 1.472-8(e)(3)(iv) (retailer, wholesaler, jobber, or distributor)
☐ Natural business unit authorized by Regulations section 1.472-8(b)(1) (manufacturer or processor)
☐ Multiple pools authorized by Regulations section 1.472-8(b)(3)(i) (manufacturer or processor)
☐ Raw material-content authorized by Regulations section 1.472-8(b)(3)(ii) (manufacturer or processor)
☐ Simplified Dollar-Value Method under section 474 (see instructions)
☐ Other (describe and justify)

9 Method used in computing LIFO value of dollar-value pools (see instructions and attach required information)
☐ Double-extension ☐ Published Price Index (describe) ☐ Index (describe and justify)
☒ Link-chain (describe and justify) ☐ Other method (describe and justify)

10 Attach a statement briefly describing the cost system used

11 Did you receive the Commissioner's permission to change your method of valuing inventories for this tax year? ☐ Yes ☐ No
If "Yes," attach a copy of the National Office's "grant letter".

12 Did you ever use the LIFO inventory method before? ☐ Yes ☐ No
If "Yes," attach a statement listing the tax years you used LIFO and explain why you discontinued it.

Under penalties of perjury, I declare that I have examined this application, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature	Title, if any	Date

Cat. No. 17057T Form 970 (Rev. 11-92)

* FILED UNDER SEC. 6.01 OF REV. PROC. 92-79

Form **3115** (Rev. November 1992) Department of the Treasury Internal Revenue Service

Application for Change in Accounting Method

▶ See instructions specifically for "Automatic Changes in Accounting Method" and "When Not To File Form 3115".

All applicants must complete pages 1 and 2.

OMB No. 1545-0152 Expires 11-30-95

Name of applicant (if joint return is filed, also give spouse's name)	Identifying number (see instructions)
Number, street, and room or suite no. (If a P.O. box, see page 2 of instructions.)	Applicant's area code and telephone number/Fax number
City or town, state, and ZIP code	District Director's office having jurisdiction
Name of person to contact (If not applicant, power of attorney must be submitted.)	Contact person's telephone number/Fax number

Check one of the following boxes:

- ☐ Individual
- ☐ Corporation
- ☐ Cooperative (Sec. 1381)
- ☐ Qualified Personal Service Corporation (Sec. 448(d)(2))
- ☐ Exempt organization. Enter code section ▶
- ☐ Partnership
- ☐ S Corporation
- ☐ Insurance Co. (Sec. 816(a))
- ☐ Insurance Co. (Sec. 831)
- ☐ Other (specify) ▶ __________

Check the box(es) for other schedules that will be completed and attach only the completed schedule(s) to pages 1 and 2 of Form 3115.

- ☐ Schedule A - Change in Overall Method of Accounting
- ☐ Schedule B - Changes Within the LIFO Inventory Method
- ☐ Schedule C - Change in the Treatment of Long-Term Contracts, Inventories, or Other Section 263A Assets
- ☐ Schedule D - Miscellaneous Changes in Method of Accounting

1a Tax year of change begins (mo., day, yr.) ▶ __________ and ends (mo., day, yr.) __________

b Enter the 180th day of the tax year ▶ __________ If this date is earlier than the date signed by the applicant on page 2, see **Late Applications** in the instructions.

2a Enter the principal business activity designated on the latest filed income tax return ▶ __________

b Enter business activity code no. (if applicable) (see instructions) ▶ __________

3 Approval is requested to change (see instructions):

a ☐ Overall method of accounting from **present method** ▶ __________ to **new method** ▶ __________

b ☑ The accounting treatment of (identify item) ▶ NEW AUTOMOBILE & NEW LIGHT-DUTY TRUCK INVENTORIES from **present method** ▶ __________ to **new method** ▶ ALTERNATE LIFO - REV. PROC. 92-79

Attach a separate statement of all relevant facts, including a detailed description of present and proposed methods and an explanation of the legal basis (statutes, regulations, published rulings, etc.) for making this application.

c If a change is requested on Item 3b above, check the present overall method of accounting that will not change:

☐ Accrual ☐ Cash ☐ Hybrid If "Hybrid" is checked, attach an explanation.

Item	Question	Yes	No
d	Number of tax years present method has been used by the applicant. (See Item 3d in the instructions.) ▶ __________		✓
e	Is the present method a "Designated A" method as defined in section 3.07 of Rev. Proc. 92-20?		✓
f	Is the present method a "Designated B" method as defined in section 3.09 of Rev. Proc. 92-20? If "Yes" to Item 3e or 3f, indicate the designating document __________		✓
g	Is the present method a "Category A" method as defined in section 3.06 of Rev. Proc. 92-20?		✓
h	Has the applicant entered into a transaction to which section 381(c)(4) or (5) applies during the tax year of change or is the applicant considering this type of transaction during the tax year of change? If "Yes," attach explanation		✓
4a	Is this the first tax year the applicant is required to change its method of accounting under section 263A, 447, 448, 460, or 585? If "Yes," state which section is applicable ▶ __________		
b	Does the applicant produce or acquire property for resale subject to section 263A? If "Yes," Schedule C, Part III must be completed if the costs to be changed are subject to section 263A.		
5a	Has the applicant or any member of the affiliated group been contacted by the IRS prior to submitting Form 3115 to schedule an examination of any of its Federal income tax returns, or is an examination in process (section 3.02 of Rev. Proc. 92-20)? If "Yes," indicate which window period under section 6 of Rev. Proc. 92-20 applies ▶ __________		✓
b	If "Yes," has a copy of Form 3115 been sent to the district director? See section 10.06 of Rev. Proc. 92-20		
c	Does the applicant have any Federal income tax returns under consideration by an appeals office or before any Federal court? See section 4 of Rev. Proc. 92-20		
d	If "Yes," has the applicant attached a written agreement from the appeals officer or counsel for the government?		
6a	In the last 6 years has the applicant applied for or changed its tax year, its overall method of accounting, or its accounting treatment of any item? If "Yes," attach a statement describing the changes and the year of change		
b	If "Yes," has a ruling letter granting approval been received? Attach an explanation if no letter was received or if a letter was received but the change was not made. Members of an affiliated group, see Item 10e		
c	Does the applicant, an affiliated corporation, or any other related corporation have pending any accounting method, tax year ruling, or technical advice request in the National Office?		

d If "Yes," indicate the name(s) of the corporation, type of request (method, tax year, etc.), and the specific issue involved in each request on an attached statement.

For Paperwork Reduction Act Notice, see page 1 of the instructions. Form 3115 (Rev. 11-92)

7a Enter the net operating loss (NOL) (if any) to be carried over to the year of change . . . .
b Enter the NOL (if any) that will expire in the year of change . . . .
c Enter the credit carryover (if any) to this year of change (identify) . . . .
d Enter the credit carryover (if any) that will expire in the year of change . . . .

Members of an affiliated group are to complete Items 7a, 7b, 7c, and 7d on a consolidated basis.

8a Gross receipts for the 4 tax years preceding the year of change. (See instructions.)

1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.	4th preceding year ended: mo. yr.

8b Taxable income for the 4 tax years preceding the year of change. (See instructions.)

1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.	4th preceding year ended: mo. yr.

	Yes	No
9a Does the applicant have more than one trade or business?		
b If "Yes," is each trade or business accounted for separately? (See instructions.)		
10a Is the applicant a member of an affiliated group filing a consolidated return for the tax year of change?		
b If "Yes," state the parent corporation's name, identifying number, address, tax year, and the service center where the return is filed ▶		
c If 10a is "Yes," do all other members of the affiliated group use the method of accounting being requested? If "No," explain ▶		
d If 10a is "Yes," are any of the items involved in determining the net section 481(a) adjustment attributable to transactions between members of the affiliated group? If "Yes," attach an explanation		
e If 10a is "Yes," provide the information requested in Items 6a and 6b, for each member of the affiliated group		
11 Are any of the items involved in determining the net section 481(a) adjustment attributable to transactions between members of a controlled group or other related parties? If "Yes," attach an explanation		✓
12a If the change is approved, will the new method be used for financial reporting purposes?		
b If "No," attach an explanation. In addition, explain whether the new method of accounting conforms to GAAP and whether it will clearly reflect income for Federal income tax purposes.		

13 Enter the net section 481(a) adjustment for the year of change, and the net section 481(a) adjustment that would have been required, if the requested change had been made for the tax year preceding the year of change. (See Item 13 in the instructions.)

Year of change	Preceding year
NONE PER SEC	9.02(6) OF
REV PROC 92	-79

	Yes	No
14 Has the net adjustment under section 481(a) for the year of change been reduced in any way by a pre-1954 amount?		✓
15 If the net section 481(a) adjustment is less than $25,000 for the year of change, does the applicant elect to take the entire net section 481(a) adjustment into account in the year of change?		

Checklist

16 Is Form 2848, Power of Attorney and Declaration of Representative, attached to this application? . . . . . . ☐ Yes ☐ No
17 Does the applicant request a conference of right at the IRS National Office? (See instructions.) . . . . ☐ Yes ☐ No
18 Enter amount of User Fee attached to this application. (See instructions on page 1.) . . . . NONE - PER SEC. 13.03 OF REV. PROC 92-79

Signature – All Applicants (See instructions.)

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Applicant	Parent corporation (if applicable)
Officer's signature and date	Parent Officer's signature and date
Name and title (print or type)	Name and title (print or type)
Signature of individual or firm preparing the application and date	Name of firm preparing the application

Name of applicant as shown on page 1	Identifying number

Schedule A - Change in Overall Method of Accounting

Attach copy(ies) of the profit and loss statement (Schedule F (Form 1040) for farmers) and the balance sheet, if applicable, as of the close of the tax year preceding the year of change. On a separate sheet, state the accounting method used when preparing the balance sheet. If books of account are not kept, attach a copy of the business schedules submitted with the Federal income tax return or other return (e.g., tax-exempt organization returns) for that period. If the amounts in Part I, Item 1 do not agree with those shown on both the profit and loss statement and the balance sheet, explain the differences on a separate sheet.

Part I Change in Overall Method (See instructions.)

1 Enter the following amounts as of the end of the tax year preceding the year of change. If none, state "None." Also provide a breakdown of the items that make up the "Amount" for lines 1a through 1g.

	Amount	Show by (✓) how treated on last year's return: Included in income or deducted as expense		Excluded from income or not deducted as expense	
a Income accrued but not received					
b Income received or reported before it was earned. State nature of income ▶					
c Expenses accrued but not paid					
d Other (specify) ▶					
e Prepaid expense previously deducted					
f Supplies on hand previously deducted					
g Inventory on hand ____ Inventory reported on applicant's return ____ Enter the difference					
h Net section 481(a) adjustment (add lines 1a-1g)					

2 Type of inventory ▶

3 Method used to value inventory: ☐ Cost ☐ Cost or market, whichever is lower ☐ Other (attach explanation)

4 Method of identifying costs in inventory: ☐ Specific identification ☐ FIFO ☐ LIFO

5a If changing to the accrual method, is the applicant also requesting to use the nonaccrual-experience method? ▶ ☐ Yes ☐ No

b If "Yes," indicate the system to be used to apply the nonaccrual-experience method ▶ ☐ Separate receivable ☐ Periodic

6 If changing to the accrual method, is the applicant also requesting the recurring item exception (section 461(h))? ☐ Yes ☐ No

Part II Change to the Cash Method (Also complete Part I. Farmers complete Part III instead of Part II. See instructions.)

1 Describe the applicant's trade or business (including operations, services performed, and types of activities, if more than one).

2 Describe the applicant's investment in capital items and leased equipment used in the trade or business, and the relationship between these items and the services performed by the business.

3 Describe inventory items (items that produce income when sold), materials and supplies used in carrying out the business.

4 Indicate the number of employees, shareholders, partners, associates, etc., and describe their duties in carrying out the applicant's business.

5 Attach a schedule showing the age of receivables for the 4 tax years preceding the year of change.

6 Attach a profit and loss statement based on the cash method for the 4 tax years preceding the year of change.

Part III Farmers - Change to the Cash Method (Also complete Part I. See instructions.)

1a Is the applicant a corporation or a partnership with a corporation as a partner that had gross receipts of $1 million or less in each of its tax years beginning after 1975? ☐ Yes ☐ No

b If "No," is the applicant eligible for any exceptions under section 447? (see instructions) ☐ Yes ☐ No

2 Gross Receipts and Inventory Information

	1st preceding yr.	2nd preceding yr.	3rd preceding yr.	4th preceding yr.	5th preceding yr.
a Gross receipts from farming					
b Inventory: Crops, etc					
Livestock held for sale: Purchased					
Raised					
Livestock held for draft, breeding, sport, or dairy purposes: Purchased					
Raised					
Total inventory					

Name of applicant as shown on page 1	Identifying number

Schedule B. - Changes Within the LIFO Inventory Method

Part I LIFO Information

Complete this section if the requested change involves changes within the LIFO inventory method. Check (✓) the appropriate boxes in 1, 2, 3, or 4 showing both the present method and the proposed method. If the present method shown in boxes 1, 2, 3, or 4 is not the same as the method shown on Form(s) 970, attach an explanation. **Note:** Attach the copy(ies) of the **Form 970(s)**, Application to Use LIFO Inventory Method, filed to adopt or expand the use of the method.

	Present method	Proposed method
1 Method for valuing inventories:		
a Unit method		
b Dollar value method		✓
2 Method for pooling:		
a By line, type, or class of goods (Regulations section 1.472-8(c))		✓
b Natural business unit (Regulations section 1.472-8(b)(1))		
c Multiple pools (Regulations section 1.472-8(b)(3)(i))		
d Raw material content (Regulations section 1.472-8(b)(3)(ii))		
e Simplified dollar value method (section 474)		
f Pooling method authorized by Regulations section 1.472-8(e)(3)(iv)		
g Other (describe)		
3 Method used to figure the cost of goods in the closing inventory over those in the opening inventory:		
a Most recent purchases		
b Earliest acquisitions during the year		
c Average cost of purchases during the year		
d Other (describe) SPECIFIC IDENTIFICATION		✓
4 Method for pricing dollar value pools:		
a Double-extension method		
b Index method*		
c Link-chain method*		✓
d Inventory Price Index computation method (see instructions)		
e Other method*		
*An example of an "other method" is the retail method using the Bureau of Labor Statistics (BLS) department store indexes. If the applicant is requesting to change to one of these methods, submit: (1) a description of the particular method, and (2) the reasons why the use of the double-extension and/or index method(s) is impractical or unsuitable for each pool.		

Part II Additional Information

1 Will the change(s) indicated above apply to all of the applicant's inventory? ☐ Yes ☑ No

2 If the change(s) indicated above applies to specific inventory pools, identify the pool(s) and describe the contents of each pool.

NEW AUTOMOBILES; NEW LIGHT-DUTY TRUCKS

3 Is the applicant requesting a change in method for its LIFO inventory that is not indicated in Part I above? ☑ Yes ☐ No

If "Yes," explain. ▶ ALL SUB-METHODS & DEFINITIONS PROVIDED IN REV. PROC. 92-79

Part III Change in Pooling LIFO Inventories

1 List and describe each dollar value pool and show the base year of each pool under the present and proposed pooling methods. *

2 Applicants engaged in the manufacturing or processing of goods and proposing to use natural business unit (NBU) pools: N/A

a Attach a description of the applicant's organization, facilities, manufacturing processes, and product lines in sufficient detail to show that each proposed NBU pool complies with Regulations section 1.472-8(b).

b Does the applicant have inventories of items purchased and held for resale? ☐ Yes ☐ No

If "Yes," attach a statement indicating that these items will not be included in any proposed NBU pool.

c Are all items, including raw materials, goods in process, and finished goods entering into the entire inventory investment for each proposed NBU pool, presently valued under the LIFO method? ☐ Yes ☐ No

If "No," attach an explanation.

3 Applicants engaged in the manufacturing or processing of goods: N/A

a If proposing to use the multiple pooling method, attach information to show that each proposed pool will consist of a group of items that are substantially similar.

b If proposing to use raw material content pools, attach information to show that each proposed pool will consist of items that are substantially similar.

4 Applicants engaged in the wholesaling or retailing of goods purchased from others:

a Attach information to show that each of the proposed pools is based upon customary business classifications of the applicant's trade or business. SEE REV. PROC. 92-79

b If proposing to use natural business unit pools, attach an explanation as to why the natural business unit pooling is appropriate. N/A

* SEE SEC 9.02(B) OF REV. PROC. 92-79

Name of applicant as shown on page 1	Identifying number

Schedule C-Change In the Treatment of Long-Term Contracts, Inventories, or Other Section 263A Assets

Part I Change In Reporting Income From Long-Term Contracts (See instructions. Complete this part and Part III below.)

1 Are the applicant's contracts long-term contracts as defined in section 460? ☐ Yes ☐ No
2 Is the applicant a manufacturer or a processor? ☐ Yes ☐ No
3 Will the applicant elect the simplified cost-to-cost method for determining the degree of contract completion? ☐ Yes ☐ No
4a Is the same method used for reporting income from all long-term contracts? ☐ Yes ☐ No
b If "No," explain other method(s). ▶
5a Do any (or all) of the applicant's contracts qualify for any of the exceptions under section 460(e) certain construction contracts? ☐ Yes ☐ No
b If "Yes" provide a separate cost allocation worksheet (Part III below) for the contracts and the method used for computing the percentage of completion method under Regulations section 1.451-3(c)(2), if applicable.
6a Is the change requested for all contracts that were outstanding at the beginning of the tax year of change? ☐ Yes ☐ No
b If "No," explain. ▶
7a Are the applicant's contracts either cost-plus long-term contracts or Federal long-term contracts? ☐ Yes ☐ No
b If "Yes," answer Items 3 through 6 above for each of those contracts. Also complete Part III below.
8 Net adjustment required under section 481(a) $

Part II Change In Valuing Inventories (See instructions and complete Part III if applicable.)

1 Describe inventory goods being changed ▶
2 Describe inventory goods (if any) not being changed ▶
3 Does the proposed change involve a change in the treatment of package design costs? ☐ Yes ☐ No
4 Is the applicant's present inventory valuation method in compliance with section 263A? ☐ Yes ☐ No
5a Check (✓) the appropriate boxes below that identify the present and proposed inventory identification and valuation methods being changed and the present inventory identification and valuation methods not being changed.

	Inventory Being Changed		Inventory Not Being Changed
	Present method	Proposed method	Present method
Identification methods:			
Specific identification			
FIFO			
LIFO*			
Valuation methods:			
Cost			
Cost or market, whichever is lower			
Retail cost			
Retail, lower of cost or market			
Other (attach explanation)			
b Enter the value at the end of the tax year preceding the year of change			

*If LIFO, attach the copy(ies) of Form 970 filed to adopt or expand the use of the method.

6 Attach the computation used to determine the section 481(a) adjustment. If the section 481(a) adjustment is based on more than one component, show the computation for each component.

Part III Method of Cost Allocation

Complete this part if the requested change involves either property subject to section 263A or to long-term contracts subject to section 460. Check (✓) the appropriate boxes in Section A to indicate the allocation and capitalization methods to be used under the present and proposed methods. Check (✓) the appropriate boxes in Sections B and C showing which costs, under both the present and proposed methods, are fully included, to the extent required, in the cost of property produced or acquired for resale under section 263A, or allocated to long-term contracts under section 460. If a box is not checked, it is assumed that those costs are not fully included to the extent required. If a cost is not fully included, attach an explanation. Mark "N/A" in a box if those costs are not incurred by the applicant with respect to its production, resale, or long-term contract activities.

Section A - Allocation and Capitalization Methods (See instructions.)

	Present method	Proposed method
1 Method of allocating indirect costs:		
Specific identification		
Standard cost		
Burden rate (attach explanation)		
Other (attach explanation)		

Continued on next page

Section A - Allocation and Capitalization Methods (Continued)

		Present method	Proposed method
2	Method of allocating service costs:		
	Direct reallocation		
	Labor-based simplified service cost		
	Simplified resale service cost		
	Simplified service cost		
	Step-allocation		
	Other (attach explanation)		
3	Method of capitalizing additional section 263A costs (including service costs):		
	Simplified production		
	Alternative simplified resale		
	U.S. ratio		
	Simplified resale		
	Modified resale		
	Other (attach explanation)		

Section B - Direct and Indirect Costs Required to be Allocated (See Regulations under sections 263A and 451.)

1	Direct material		
2	Direct labor		
3	Repairs that relate to a production, resale, or long-term contract activity		
4	Maintenance		
5	Utilities		
6	Rent		
7	Indirect labor and production supervisory wages		
8	Indirect materials and supplies		
9	Tools and equipment		
10	Quality control and inspection		
11	Taxes other than state, local, and foreign income taxes		
12	Depreciation, amortization, and cost recovery allowance for equipment and facilities placed in service and not temporarily idle		
13	Depletion		
14	Administrative costs (not including any costs of selling or any return on capital)		
15	Direct or indirect costs of other administrative, service, or support function or department		
16	Officers' compensation (not including selling activities)		
17	Insurance		
18	Employee benefits		
19	Research and experimental expenses attributable to long-term contracts		
20	Rework labor, scrap, and spoilage		
21	Bidding expenses incurred in the solicitation of particular contracts ultimately awarded to the applicant		
22	Engineering and design costs (not including section 174 research and experimental expenses)		
23	Storage and warehousing costs including a portion of allocable general and administrative costs*		
24	Purchasing costs including a portion of allocable general and administrative costs		
25	Handling, processing, assembly, and repackaging costs including a portion of allocable general and administrative costs		
26	Interest		
27	Other costs (Attach a list of such costs.)		
	* Resalers may distinguish between off-site and on-site storage and do not have to capitalize on-site storage costs. Check if the applicant is only allocating off-site storage costs ▶ ☐		

Section C - Other Costs (Not required to be allocated)

1	Repairs that do not relate to a production, resale, or long-term contract activity		
2	Research and experimental expenses not included on line 19 above		
3	Bidding expenses not included on line 21 above		
4	Marketing, selling, advertising, and distribution expenses		
5	General and administrative costs attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular production, resale, or long-term contract activity		
6	Income taxes		
7	Cost of strikes		
8	Other costs (Attach a list of such costs.)		

Name of applicant as shown on page 1	Identifying number

Schedule D - Miscellaneous Changes in Method of Accounting

Part I Change in Reporting Interest on Loans and Other Debt Obligations (See instructions.)

1 Change requested for interest on: ☐ Installment loans ☐ Commercial loans
☐ Other loans (attach an explanation) ▶ ______
Other debt obligations (attach an explanation) ▶ ______

2 Amount of earned or realized interest that has not been reported on the applicant's return as of the end of the tax year preceding the year of change . . . . . ______

3 Amount of unearned or unrealized interest that has been reported on the applicant's return as of the end of the tax year preceding the year of change . . . . . ______

4 Do the applicant's installment loans meet the definition of short-term consumer loans as defined in Rev. Proc. 83-40, 1983-1 C.B. 774? . . . . . ☐ Yes ☐ No
If applying to change from the sum of the months digits method (rule of 78's) to the economic accrual of interest method for reporting interest (discount) under Rev. Rul. 83-84, 1983-1 C.B. 97, see Rev. Procs. 84-30, 1984-1 C.B. 482.

5 Method of rebating in event of prepayment of loans ▶ ______

6 Does the applicant's requested method change involve any of the following items? (check appropriate boxes)
☐ Points ☐ Service fees ☐ Commitment fees
If any box(es) above are checked, attach a description of any interest and/or fees charged.

7 If the "Points" box is checked:
a Are the points for the use or forbearance of money (interest)? . . . . . ☐ Yes ☐ No
b Are the points deductible by the borrower under section 461(g)(2)? . . . . . ☐ Yes ☐ No
c If the borrower pays the points prior to settlement, are they refundable if the loan is not made? . . . . . ☐ Yes ☐ No
d What type of loan(s) (commercial, residential, home mortgage, etc.) do the points apply? ______

8 If more than one box is checked in Item 6, attach the section 481(a) adjustment for the year of change and for the 3 preceding tax years attributable to each item checked.

8 Is the applicant's requested method change subject to the rules for bonds, debt instruments, and other evidence of indebtedness under section 1272, 1274, or 1281? . . . . . ☐ Yes ☐ No

10a If any of the boxes in question 6 are checked and question 9 is checked "No," does the proposed method change comply with Rev. Rul. 70-540, 1970-2 C.B. 101? . . . . . ☐ Yes ☐ No
b If "Yes," explain how Rev. Rul. 70-540 applies. ▶ ______

Part II Change in Depreciation Under Section 167 (See instructions.)

Applicants requesting approval to change their method of accounting for depreciation under section 167 must complete this section. This information must be supplied for each account for which a change is requested.

Note: Certain changes in methods of accounting for depreciation may be filed with the service center where the income tax return will be filed. See Rev. Proc. 74-11, 1974-1 C.B. 420, for the methods covered. For information regarding elections and election revocations under section 168, see the instructions.

1 Date of acquisition of the property being depreciated ▶ ______
2a Is the applicant the original owner or the first user of the property? . . . . . ☐ Yes ☐ No
b If residential property, did the applicant live in the home before renting it? . . . . . ☐ Yes ☐ No
3 Is depreciation claimed under Regulations section 1.167(a)-11 (CLADR)? . . . . . ☐ Yes ☐ No
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).
4 Is the property public utility property? . . . . . ☐ Yes ☐ No
5 Location of the property (city and state) ▶ ______
6 Description of the property ▶ ______
7 Cost or other basis of the property and adjustments made to the property (exclude land) . . . . . ______
8 Depreciation claimed in prior tax years (depreciation reserve) . . . . . ______
9 Estimated salvage value . . . . . ______
10 Estimated remaining useful life of the property ▶ ______
11 If the declining balance method is requested, show percentage of straight-line rate ▶

Continued on next page

Part III Change in Treatment of Property Used in a Trade or Business (See instructions.)

Indicate the type of property for which the change in accounting method is requested. For each type of property checked, provide a complete description and a list of items that is representative of that type of property.

- ☐ Depreciable asset(s) subject to section 167.
- ☐ Materials and supplies used in operations and deductible as a deferred expense under Regulations section 1.162-3.
- ☐ Incidental materials and supplies for which no record of consumption is kept or no physical inventories are taken.
- ☐ Parts that are repeatedly repaired and reused.
- ☐ Parts that are repeatedly repaired and reused that qualify as "standby replacement parts" as defined in Rev. Rul. 69-200, 1969-1 C.B. 60.
- ☐ Parts that qualify as "emergency spare parts" as defined in Rev. Rul. 81-185, 1981-2 C.B. 59.
- ☐ Other (specify)

Part IV Change in Reporting Advance Payments (See instructions.)

1 If applicant is requesting to defer advance payment for services, complete the following:

a Provide a description of the income to be deferred, a sample contract and the applicant's authority for deferring the income.

b Does the service agreement request that all services be performed by the end of the next succeeding tax year? ☐ Yes ☐ No

c Is the agreement for contingent services? ☐ Yes ☐ No

d If "Yes," answer the following questions:

(1) Is the service agreement related to merchandise that is sold, leased, installed, or constructed by the applicant? ☐ Yes ☐ No

(2) If "Yes," does the applicant offer to sell, build, lease, install, or construct without the service agreement? ☐ Yes ☐ No

(3) What method will be used to determine the amount of income earned in a tax year? (Check one)

☐ Statistical basis ☐ Straight line ratable basis ☐ Other (attach explanation)

2 If the applicant is requesting to defer advance payment for goods, complete the following:

a Describe the advance payments as they occur in the normal course of business.

b Is the deferral in accordance with Regulations section 1.451-5? ☐ Yes ☐ No

3 Is the applicant changing its method for customer deposits? ☐ Yes ☐ No

If "Yes," answer the following questions:

a Is the applicant a public utility? ☐ Yes ☐ No

b Are deposits fully refundable at the request of the customer? (Attach an explanation of the refund policy.) ☐ Yes ☐ No

c Is the interest paid on the deposits? ☐ Yes ☐ No

d Are deposits required only for certain customers? ☐ Yes ☐ No

If "Yes," explain which customers are required to make deposits.

4 Is the applicant requesting to defer advance payments for prepaid subscription income? (See section 455 and Rev. Proc. 84-76, 1984-2 C.B. 751.) ☐ Yes ☐ No

5 Is the applicant requesting to defer advance payments for membership dues under section 456? ☐ Yes ☐ No

6 If the applicant has advance payments for any other item, complete the following:

a Describe the income

b State the legal basis (statutes, regulations, published rulings, etc.) for requesting approval to change the method of reporting advance payments. ▶

Part V Other Changes in Method of Accounting (See instructions.)

Under penalties of perjury, ______________________ agrees to all of the conditions of consent, contained in Section 9 of Rev. Proc. 92-79, to change to the Alternate LIFO Method.

Form **8300**
(Rev. August 1994)
Department of the Treasury
Internal Revenue Service

Report of Cash Payments Over $10,000 Received in a Trade or Business

▶ See instructions for definition of cash.

Please type or print.

OMB No. 1545-0892

1 Check appropriate boxes if: a ☐ amends prior report; b ☐ suspicious transaction.

Part I Identity of Individual From Whom the Cash Was Received

2 If more than one individual is involved, see instructions and check here ▶ ☐

3 Last name | 4 First name | 5 M.I. | 6 Social security number

7 Address (number, street, and apt. or suite no.) | 8 Date of birth (see instructions)

9 City | 10 State | 11 ZIP code | 12 Country (if not U.S.) | 13 Occupation, profession, or business

14 Method used to verify identity: a Describe identification ▶

b Issued by c Number

Part II Person (See Definitions) on Whose Behalf This Transaction Was Conducted

15 If this transaction was conducted on behalf of more than one person, see instructions and check here. ▶ ☐

16 Individual's last name or Organization's name | 17 First name | 18 M.I. | 19 Social security number

20 Doing business as (DBA) name (see instructions)

Employer identification number

21 Alien identification: a Describe identification ▶

b Issued by c Number

22 Address (number, street, and apt. or suite no.) | 23 Occupation, profession, or business

24 City | 25 State | 26 ZIP code | 27 Country (if not U.S.)

Part III Description of Transaction and Method of Payment

28 Date cash received | 29 Total cash received $ .00 | 30 If cash was received in more than one payment, check here | 31 Total price if different from item 29 $ .00

32 Amount of cash received (in U.S. dollar equivalent) (see instructions):

a U.S. currency $ ______ .00 (Amount in $100 bills or higher $ ______ .00)

b Foreign currency ______ .00 (Country ▶ ______)

c Cashier's check(s) ______ .00

d Money order(s) ______ .00

e Bank draft(s) ______ .00

f Traveler's check(s) ______ .00

Issuer's name(s) and serial number(s) of the monetary instrument(s) ▶

33 Type of transaction

a ☐ personal property purchased

b ☐ real property purchased

c ☐ personal services provided

d ☐ business services provided

e ☐ intangible property purchased

f ☐ debt obligations paid

g ☐ exchange of cash

h ☐ escrow or trust funds

i ☐ other (specify) ▶

34 Specific description of property or service shown in 33. (Give serial or registration number, address, etc.)

▶

Part IV Business That Received Cash

35 Name of business that received cash | 36 Employer identification number

37 Address (number, street, and apt. or suite no.) | Social security number

38 City | 39 State | 40 ZIP code | 41 Nature of your business

42 Under penalties of perjury, I declare that to the best of my knowledge the information I have furnished above is true, correct, and complete.

Sign Here

(Authorized signature of business that received cash) | (Title) | (Date signed) | (Telephone number of business)

Form **8300** (Rev. 8-94)

Multiple Parties

(Complete applicable parts below if box 2 or 15 on page 1 is checked)

Part I **Continued - Complete if box 2 on page 1 is checked**

3 Last name	4 First name	5 M.I.	6 Social security number
7 Address (number, street, and apt. or suite no.)			8 Date of birth (see instructions)
9 City	10 State / 11 ZIP code	12 Country (if not U.S.)	13 Occupation, profession, or business

14 Method used to verify identity: a Describe identification ▶

b Issued by c Number

3 Last name	4 First name	5 M.I.	6 Social security number
7 Address (number, street, and apt. or suite no.)			8 Date of birth (see instructions)
9 City	10 State / 11 ZIP code	12 Country (if not U.S.)	13 Occupation, profession, or business

14 Method used to verify identity: a Describe identification ▶

b Issued by c Number

Part II **Continued - Complete if box 15 on page 1 is checked**

16 Individual's last name or Organization's name	17 First name	18 M.I.	19 Social security number
20 Doing business as (DBA) name (see instructions)			Employer identification number
21 Alien identification: a Describe identification ▶			
b Issued by c Number			
22 Address (number, street, and apt. or suite no.)		23 Occupation, profession, or business	
24 City	25 State / 26 ZIP code	27 Country (if not U.S.)	

16 Individual's last name or Organization's name	17 First name	18 M.I.	19 Social security number
20 Doing business as (DBA) name (see instructions)			Employer identification number
21 Alien identification: a Describe identification ▶			
b Issued by c Number			
22 Address (number, street, and apt. or suite no.)		25 Occupation, profession, or business	
24 City	25 State / 26 ZIP code	27 Country (if not U.S.)	

Form **8807**
(Rev. January 1994)
Department of the Treasury
Internal Revenue Service

Certain Manufacturers and Retailers Excise Taxes

▶ Attach to Form 720.

OMB No. 1545-1076
Expires 5-31-96

Name (as shown on Form 720)	Quarter ending	Employer identification number

A Are you required to file **Form 2290**, Heavy Vehicle Use Tax Return? . . . . . ☐ Yes ☐ No

B Are you registered on **Form 637**, Application for Registration? . . . . . ☐ Yes ☐ No

If "Yes," please enter your registration number here . . . . . ▶

Part I Computation of Tax on All Items Except Passenger Vehicles

	(a) Truck, trailer, and semitrailer chassis and bodies, and tractors	(b) Sport fishing equipment	(c) Electric outboard motors and sonar devices	(d) Bows and arrows
	IRS No. 33	IRS No. 41	IRS No. 42	IRS No. 44
1 Total sales				
2 Sales included on line 1 from imports				
3 Subtractions from sales. Include tax-free sales, tax-exempt sales, tax-paid purchases, and exports				
4 Net taxable sales (line 1 less line 3)				
5 Credits or adjustments. Include delivery expenses, tire credits, tax-paid parts and accessories, and other credits or adjustments				
6 Taxable amount (line 4 less line 5)				
7 Tax rate	.12	.1	.03	.11
8 Amount of tax (multiply line 6 by line 7). Enter the amount of tax on Form 720 on the line for the IRS No.				

Part II Computation of Luxury Tax on Passenger Vehicles

	Passenger vehicles
	IRS No. 92
1 Taxable adjusted sales price of first retail sales of passenger vehicles, from line 7 of Worksheet I	
2 Taxable amount of subsequent additions to passenger vehicles, from line 7 of Worksheet II	
3 Taxable fair market value (FMV) on changes in use of passenger vehicles	
4 Taxable amount (add lines 1, 2, and 3)	
5 Tax rate	.1
6 Tax (multiply line 4 by line 5). Enter the tax on Form 720 on the line for IRS No. 92	

Form **8807** (Rev. 1-94)

Form **720**
(Rev. October 1994)
Department of the Treasury
Internal Revenue Service

Quarterly Federal Excise Tax Return

Use To Report Excise Taxes for 1994.
▶ For Paperwork Reduction Act Notice, see the separate instructions.

OMB No. 1545-0023

If you are not using a preprinted label, enter your name, address, employer identification number, and calendar quarter of return. See the separate instructions. ▶

Name | Quarter ending
Number, street, and room or suite no. (If you have a P.O. Box, see page 2.) | Employer identification number
City, state, and ZIP code (If you have a foreign address, see page 2.)

FOR IRS USE ONLY	
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Final Return: If this is a final return or a one-time filing, check this box ▶ ☐

Part I

IRS No.	Environmental Taxes (Attach Form 6627 for all environmental taxes.)	Tax	IRS No.
53	Domestic petroleum superfund tax and oil spill tax		53
16	Imported petroleum products superfund tax and oil spill tax		16
54	Chemicals		54
17	Imported chemical substances		17
98	Ozone-depleting chemicals (ODCs)		98
19	Imported products containing ODCs		19
IRS No.	**Communications and Air Transportation Taxes**	**Tax**	**IRS No.**
22	Toll telephone service, teletypewriter exchange service, and local telephone service		22
26	Transportation of persons by air		26
28	Transportation of property by air		28
27	Use of international air travel facilities		27

IRS No.	Fuel Taxes	Number of gallons	Rate	Tax	IRS No.
60	(a) Diesel fuel, tax on removal at terminal rack		.244		60
	(b) Diesel fuel, tax on taxable events other than removal at terminal rack, including tax on liquids blended with previously taxed diesel fuel		.244		
71	Dyed diesel fuel used in trains		.069		71
78	Dyed diesel fuel used in certain intercity buses		.074		78
61	Special motor fuels		.184/.183		61
79	Other alcohol fuels		(See instructions.)		79
62	(a) Gasoline, tax on removal at terminal rack		.184		62
	(b) Gasoline, tax on taxable events other than removal at terminal rack		.184		
	(c) Gasoline, tax on failure to blend or later separation		(See instructions.)		
58	Gasoline sold for gasohol production containing at least 10% alcohol		.1444		58
73	Gasoline sold for gasohol production containing at least 7.7% alcohol but less than 10% alcohol		.1542		73
74	Gasoline sold for gasohol production containing at least 5.7% alcohol but less than 7.7% alcohol		.1624		74
59	Gasohol containing at least 10% alcohol		.13		59
75	Gasohol containing at least 7.7% alcohol but less than 10% alcohol		.1424		75
76	Gasohol containing at least 5.7% alcohol but less than 7.7% alcohol		.1532		76
69	Aviation fuel (other than gasoline)		.219		69
14	Gasoline for use in noncommercial aviation		.01		14
77	LUST tax on aviation fuel (other than gasoline)		.001		77
101	Compressed natural gas (taxed at $.4854 per thousand cubic feet)				101

Form **720** (Rev. 10-94)

IRS No.	Retail Tax (Attach Form 8807.)			Tax	IRS No.
33	Truck, trailer, and semitrailer chassis and bodies, and tractors				33
IRS No.	**Ship Passenger Tax**	**Number of persons**	**Rate**	**Tax**	**IRS No.**
29	Transportation by water		$3 per person		29
IRS No.	**Other Excise Tax**	**Amount of obligations**	**Rate**	**Tax**	**IRS No.**
31	Obligations not in registered form		$ .01		31
IRS No.	**Luxury Tax (Attach Form 8807.)**			**Tax**	**IRS No.**
92	Passenger vehicles				92

IRS No.	Manufacturers Taxes	Number of tons	Sales price	Rate	Tax	IRS No.
36	Coal - Underground mined			$1.10 per ton		36
37				4.4% of sales price		37
38	Coal - Surface mined			$ .55 per ton		38
39				4.4% of sales price		39
66	Highway-type tires (See instructions.)					66
40	Gas guzzler tax **(Attach Form 6197.)**					40

IRS No.	Vaccine Taxes	Number of doses	Rate	Tax	IRS No.
81	DPT vaccine		$4.56		81
82	DT vaccine		.06		82
83	MMR vaccine		4.44		83
84	Polio vaccine		.29		84
IRS No.	**Foreign Insurance Taxes**	**Premiums paid**	**Rate**	**Tax**	**IRS No.**
	Policies issued by foreign insurers (See instructions.)				
	Casualty insurance and indemnity bonds		$ .04		
30	Life insurance, sickness and accident policies, and annuity contracts		.01		30
	Reinsurance		.01		

1 **Total. Add all amounts in Part I. Attach Schedule A unless one-time filing** ▶ $

Part II

IRS No.				Tax	IRS No.
41	Sport fishing equipment **(Attach Form 8807.)**				41
42	Electric outboard motors and sonar devices **(Attach Form 8807.)**				42
44	Bows and arrows **(Attach Form 8807.)**				44
IRS No.		**Number of gallons**	**Rate**	**Tax**	**IRS No.**
64	Inland waterways fuel use tax		$ .234		64
51	Alcohol sold as but not used as fuel (See instructions.)		.54/.40		51
IRS No.	**Floor Stocks Taxes**			**Tax**	**IRS No.**
20	Ozone-depleting chemicals (floor stocks) **(Attach Form 6627.)**				20

2 **Total. Add all amounts in Part II** ▶ $

Part III

3 Total tax. Add line 1, Part I and line 2, Part II 3

4 Adjustments and claims (See instructions. **Attach Schedule C.**) 4

5 Tax as adjusted. Combine lines 3 and 4. Enter the result here, using brackets if less than zero. (If no entry on line 4, enter amount from line 3.) 5

6 Deposits you made for the quarter . . . . . ▶ 6

7 Overpayment from previous quarter . . . . . ▶ 7

8 Total of lines 6 and 7 . . . . . ▶ 8

9 BALANCE DUE. If line 5 is greater than line 8, enter the difference. This amount must be paid with the return. Attach check or money order for full amount payable to "Internal Revenue Service." Write your EIN, Form 720, and the quarter on it . . . . . ▶ 9

10 OVERPAYMENT. If line 8 is greater than line 5, enter the difference. If you have an entry that is less than zero (in brackets) on line 5, add line 5 and line 8. Check if you want it: 10

☐ **Applied to your next return, or** ☐ **Refunded to you.**

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

▶ Signature | Date ▶ Title

(Please type or print name below signature.) Telephone number ( )

Schedule A Excise Tax Liability

Note: You must file Schedule A if you have a liability for any tax in Part I of Form 720. Do not use Schedule A for taxes on bows and arrows, electric outboard motors and sonar devices, sport fishing equipment, alcohol sold as but not used as fuel, or inland waterways fuel use; for any floor stocks taxes; or for one-time filings.

1 9-day-rule taxes (See instructions.)

(a) Record of Net Tax Liability	Period: 1st-15th day	Period: 16th-last day
First month	A	B
Second month	C	D
Third month	E	F

(b) Net liability for 9-day-rule taxes. (Add the amounts for each semimonthly period.)

2 30-day-rule taxes (IRS Nos. 19 and 98)

(a) Record of Net Tax Liability	Period: 1st-15th day	Period: 16th-last day
First month	G	H
Second month	I	J
Third month	K	L

(b) Net liability for 30-day-rule taxes. (Add the amounts for each semimonthly period.)

3 Collected taxes based on billings or tickets sold (IRS Nos. 22, 26, 27, and 28) (See instructions.)

(a) Record of Taxes Considered as Collected	Period: 1st-15th day	Period: 16th-last day
First month	M	N
Second month	O	P
Third month	Q	R

(b) Collected taxes based on billings or tickets sold. (Add the amounts for each semimonthly period.)

4 14-day-rule gasoline and diesel fuel taxes (IRS Nos. 60, 62, 58, 73, 74, 59, 75, and 76) (See instructions.)

(a) Record of Net Tax Liability	Period: 1st-15th day	Period: 16th-last day
First month	S	T
Second month	U	V
Third month	W	X

(b) Net liability for 14-day-rule gasoline and diesel fuel taxes. (Add the amounts for each semimonthly period.)

Form **6627** (Rev. January 1995) Department of the Treasury Internal Revenue Service

Environmental Taxes

▶ See the separate instructions.
▶ Attach to Form 720.

OMB No. 1545-0245

Name (as shown on Form 720)	Quarter ending	Employer identification number

Part I Tax on Petroleum

	(a) Barrels	(b) Rate	(c) Tax
1 Crude oil received at a U.S. refinery			
2 Crude oil taxed before receipt at refinery			
3 Taxable crude oil (subtract line 2 from line 1). Enter in column (c) the amount of tax by multiplying column (a) by column (b)		$ .097 bbl.	$
4 Crude oil used in or exported from the U.S. before the tax was imposed. Enter in column (c) the amount of tax by multiplying column (a) by column (b)		$ .097 bbl.	$
5 Total domestic petroleum superfund tax (add lines 3 and 4, column (c)). Enter here and on Form 720 on the line for **IRS No. 53** ▶			$
6 Imported petroleum products superfund tax. Enter the number of barrels imported in column (a). Enter in column (c) the amount of tax by multiplying column (a) by column (b), and also enter it on Form 720 on the line for **IRS No. 16** ▶		$ .097 bbl.	$

Part II Tax on Chemicals (Other Than Ozone-Depleting Chemicals (ODCs)), IRS No. 54

Chemical (General formula or symbol)	(a) Tons	(b) Rate	(c) Tax (multiply column (a) by column (b))	Chemical (General formula or symbol)	(a) Tons	(b) Rate	(c) Tax (multiply column (a) by column (b))
1 Acetylene (C_2H_2)		$4.87		22 Hydrochloric acid (HCl)		$0.29	
2 Ammonia (NH_3)		2.64		23 Hydrogen fluoride (HF)		4.23	
3 Antimony (Sb)		4.45		24 Lead oxide (PbO)		4.14	
4 Antimony trioxide (Sb_2O_3)		3.75		25 Mercury (Hg)		4.45	
5 Arsenic (As)		4.45		26 Methane (CH_4)		3.44	
6 Arsenic trioxide (As_2O_3)		3.41		27 Naphthalene ($C_{10}H_8$)		4.87	
7 Barium sulfide (BaS)		2.30		28 Nickel (Ni)		4.45	
8 Benzene (C_6H_6)		4.87		29 Nitric acid (HNO_3)		0.24	
9 Bromine (Br)		4.45		30 Phosphorus (P)		4.45	
10 Butadiene (C_4H_6)		4.87		31 Potassium dichromate ($K_2Cr_2O_7$)		1.69	
11 Butane (C_4H_{10})		4.87		32 Potassium hydroxide (KOH)		0.22	
12 Butylene (C_4H_8)		4.87		33 Propylene (C_3H_6)		4.87	
13 Cadmium (Cd)		4.45		34 Sodium dichromate ($NaCr_2O_7$)		1.87	
14 Chlorine (Cl)		2.70		35 Sodium hydroxide (NaOH)		0.28	
15 Chromite ($FeCr_2O_4$)		1.52		36 Stannic chloride ($SnCl_4$)		2.12	
16 Chromium (Cr)		4.45		37 Stannous chloride ($SnCl_2$)		2.85	
17 Cobalt (Co)		4.45		38 Sulfuric acid (H_2SO_4)		0.26	
18 Cupric oxide (CuO)		3.59		39 Toluene (C_7H_8)		4.87	
19 Cupric sulfate ($CuSO_4$)		1.87		40 Xylene (C_8H_{10})		4.87	
20 Cuprous oxide (Cu_2O)		3.97		41 Zinc chloride ($ZnCl_2$)		2.22	
21 Ethylene (C_2H_4)		4.87		42 Zinc sulfate ($ZnSO_4$)		1.90	

43 **Total Chemical Tax** (add lines 1-42, column (c)). Enter here and on Form 720 on the line for **IRS No. 54** ▶ $

For Paperwork Reduction Act Notice, see the separate instructions. Form **6627** (Rev. 1-95)

Part III Tax on Imported Chemical Substances, IRS No. 17

	(a) Imported chemical substance	(b) Tons	(c) Taxable chemical used in manufacture of substance	(d) Conversion factor, percentage of metal, or entry value	(e) Rate	(f) Tax (see instructions)
1						
2						
3						
4	**Total Imported Chemical Substances Tax.** Add all amounts in column (f). Enter here and on Form 720 on the line for **IRS No. 17** ▶					$

Part IV Tax on Ozone-Depleting Chemicals (ODCs), IRS No. 98

Elections. - If you elect to report the tax on post-1989 ODCs at the time you sell or use a mixture containing such chemicals instead of when you make the mixture, check this box (the 1990 election). ☐

If you elect to report the tax on post-1990 ODCs at the time you sell or use a mixture containing such chemicals instead of when you make the mixture, check this box (the 1991 election). ☐

	(a) Ozone-depleting chemical	(b) Number of pounds	(c) Tax per pound (See Part IV instructions.)	(d) Tax (multiply column (b) by column (c))
1				
2				
3				
4	**Total Ozone-Depleting Chemicals Tax.** Add all amounts in column (d). Enter here and on Form 720 on the line for **IRS No. 98** ▶			$

Part V ODC Tax on Imported Products, IRS No. 19

Election. - If you elect to report the tax on imported products at the time you import the products instead of when you sell or use the products, check this box. ☐

	(a) Imported product	(b) Number of products	(c) ODC weight of product	(d) Tax per pound	(e) Entry value	(f) Tax (see instructions)
1						
2						
3						
4	**Total ODC Tax on Imported Products.** Add all amounts in column (f). Enter here and on Form 720 on the line for **IRS No. 19** ▶					$

Part VI Tax on Floor Stocks of ODCs, IRS No. 20

	(a) Ozone-depleting chemical	(b) Number of pounds	(c) Tax per pound (See Part VI instructions.)	(d) Tax (multiply column (b) by column (c))
1				
2				
3				
4	**Total Floor Stocks Tax.** Add all amounts in column (d). Enter here and on Form 720 on the line for **IRS No. 20** ▶			$

Table of Contents

Chapter 100

Introduction

110 *(12-7-76)* 4232.2
Purpose

(1) This handbook has been prepared to assist you in the examination of income tax returns of automobile and mobile home dealers.

(2) Through diligent use of this handbook you will shorten the time needed to acquire the auditing skill essential for auditing returns in this industry. Of course, nothing contained herein should discourage you from improving upon these techniques or from exercising your own initiative and ingenuity.

120 *(12-7-76)* 4232.2
Contents

(1) This handbook is a compilation of the auditing techniques used by some of our most experienced revenue agents.

(2) The auditing methods and techniques in this issuance are permissive and not intended to be mandatory procedures and instructions for field personnel.

(3) This handbook does not alter existing technical or procedural instructions in the IR Manual. In the event of any inconsistencies between this handbook and the basic text of the IR Manual, the basic text will prevail. Procedural statements in this issuance are for emphasis and clarity and are not to be taken as authority for administrative action.

130 *(12-7-76)* 4232.2
Distribution

This Handbook is distributed under a schedule, based on a recent survey, providing its issuance to Audit personnel in the districts, regions and National Office having a need for information relating to Auto Dealers.

Chapter 200

Automobile Dealers

210 *(12-7-76)* 4232.2
General

(1) When an automobile dealer sells an automobile, he/she may receive cash, a used car trade-in, and a note signed by the purchaser payable to the dealer, or any combination of these. When a note is involved, it normally is endorsed by the dealer to a finance company. Also, in order to maintain continuity in his/her automobile sales, the dealer may operate a service department and sell replacement parts. Around this departmental organization are built the accounting systems of automobile dealers. Dealers in new automobiles are required to use the accounting systems prescribed by the automobile manufacturers whose product they sell. It is advisable that the agent procure, whenever practicable, the accounting manual from the automobile dealer for use as a guide during the audit.

(2) Dealers in new automobiles submit financial reports to the automobile manufacturer whose product they sell, on a weekly, monthly or yearly basis, depending on the type of report. These reports should be inspected and reconciled with the dealer's federal income tax return as this procedure may lead to unreported sales, inventory discrepancies, or other valuable information concerning income and expenses. These periodic dealer statements include income statements and balance sheets. Automobile manufacturers keep a close watch on the statements submitted by dealers and often audit these statements with the automobile dealer's records. On these statements, accounts under the headings "Additions to Income" and "Deductions from Income" cover transactions other than regular day-to-day business and should be thoroughly checked.

(3) Used car dealers specialize in the sale of used cars only. They commonly do not maintain the many services of the new car dealer and as a result, can operate with much lower overhead. Most used car dealers do not have a showroom and sell their cars from open lots. Their repair departments, if any, are maintained primarily for the reconditioning of their cars and not for servicing the general public.

(4) The problems involved in determing gross profits to be reported on the tax returns of automobile dealers are fairly standard throughout the United States. The dealer has no alternative but to compute his/her gross profit on the accrual basis since inventories are a material income-producing factor.

(5) As a matter of general interest, in contests where prizes in excess of $600 may be won, Forms 1099 are issued by the factory. These are policed by the Detroit District when examining the manufacturers. They have, in some instances, prepared lists of winners and submitted them to the National Office. In those contests in which points earned may be pooled, the agent should be aware of the practice and make inquiries as to contest winners.

220 *(12-7-76)* 4232.2
Income

221 *(12-7-76)* 4232.2
Sales

(1) Sales are usually recorded at dealer-established list price of new cars sold to retail customers, fleet customers and other dealers. The sales price includes the basic cost of the car, options, delivery, etc. In the case of new cars, the accessories may be included in the sales price or may be reported separately.

(2) Leads for unreported sales may be found in the following manner.

(a) By checking the financial statements submitted to the automobile manufacturer since all automobiles must be accounted for on these statements.

(b) By checking the registration of automobiles with the state.

(c) By checking freight charges incurred for automobiles purchased to see if all sales are being reported and that no automobiles on hand have been omitted from the ending inventory.

(d) By checking sales tax payments (if any) to the state against sales.

(e) By checking deposits made by customers to apply against their future purchases. This may lead to the improper deferment of sales to the following year. Old items appearing in this account should be carefully examined to determine the possibility of their being adjusted to income as omissions from the sales price.

(f) By checking the financing of customers' installment obligations to see if all sales are being reported. Also check to see if all sales are being reported which involve a "dealer reserve holdback" of part of the installment obligation. See 222.2 concerning finance company "holdbacks."

(g) By checking sales prices on used cars with market quotations for a test period through use of an appraisal book such as the "blue book" published by the National Automobile Dealers' Association.

(h) By checking delivery preparation cost to assure that factory reimbursement is properly shown.

(i) By checking with the wholesale used car auction dealer for unreported sales. The used car auction dealer maintains records on each automobile handled.

222 *(12-7-76)* 4232 2
Finance Income and Discounting Installment Notes Receivable

222.1 *(12-7-76)* 4232 2
General

(1) Most automobile dealers sell the majority of their automobiles under some type of conditional sales contract involving an installment note. The face amount of these notes will include the unpaid balance on the automobile plus finance charges. As previously mentioned, it is a common practice for the dealer to endorse or sell this installment note to a finance company. It is this transaction that normally creates what is known in the trade as the "dealers' reserve." To understand the meaning of "dealers' reserve," it is necessary to first understand the system of retail financing commonly involved.

(2) There are three major types of agreements which may be made between an automobile dealer and a finance company. The first agreement is the "Repurchase Plan." This plan provides that the dealer will repurchase from the finance company, for the amount of the unpaid balance of the note, any automobile which must be repossessed from the buyer by the finance company. The finance company must first repossess the automobile and turn it over to the dealer, otherwise, the latter is released from all responsibility, and the loss, if any, must be borne only by the finance company.

(3) The second type of agreement is known as the "Recourse Plan." Under this plan the dealer endorses to the finance company "with recourse" all notes received from buyers of automobiles. Should there be a default on an installment note, the dealer must make good the unpaid balance of the note. The dealer of course gets the repossessed automobile. The finance company has recourse against the dealer but not the chattel. The "Repurchase Plan" cited previously is really a modification of the "Recourse Plan."

(4) The third type of agreement is known as the "Non-recourse Plan." Under this plan the dealer, upon sale of the conditional sales contracts, endorses the notes "without recourse" and he/she is relieved of all liability. In such cases the finance company owns any cars which are repossessed. The dealer immediately receives payment for the purchase price of the automobile and the finance commission.

222.2 *(12-7-76)* 4232.2
Dealer Reserve Holdback

(1) Finance companies usually pay commissions to automobile dealers who sell installment notes to them. These commissions sometimes are paid immediately to the automobile dealer, or they may be withheld to cover contingent bad debts and credited to a "dealer reserve holdback" account. Amounts held in the reserve in such cases, cannot be excluded from the income of the dealer, since the dealer is on the accrual basis of accounting.

(2) Consider the following example of a typical transaction involving the sale of an automobile involving both a cash down payment and a trade-in:

Sales price of automobile (used)		$1,200.00
Less Down payment—cash	$100.00	
Down payment—trade-in	300.00	400.00
Balance of sales price to be financed		$ 800.00
(Same amount usually remitted to the dealer by the finance company when buyer's note has been endorsed to the finance company)		
Insurance		40.00
Finance Charges @ 10%		80.00
(There are variations in rates used)		
Amount or face of note payable by purchaser		$ 920.00

(3) Assuming the dealer's finance-charge commissions are based on one-fifth of such charges, the following entries would be made:

(a) The finance company would make the following entry on its books:

	Debit	Credit
Installment notes receivable	$920.00	
Cash		$800.00
Insurance payable		40.00
Finance charges (deferred income)		64.00
Dealers' reserve holdback		16.00

(b) The automobile dealer would make the following entry on its books:

	Debit	Credit
Cash	$800.00	
Dealers' reserve holdback	16.00	
Customers' account receivable		$800.00
(or "contract in transit")		
Finance commissions earned		16.00

(4) The automobile dealer and the finance company may agree that a portion of the installment note, exclusive of the insurance and finance charges is to be retained by the finance company in a "dealer reserve holdback" or other comparable account until collections are made, or the reserve reaches a specified total. At such time, the amount held back is paid or credited to the dealer. Amounts held in the reserve in such cases should not be excluded from income of the dealer. This may be attempted by offsetting such dealer reserve holdback against sales or by a direct deduction. The full amount due the dealer, undiminished by the portion retained by the finance company, is properly included in income at the time the installment notes are sold under the accrual method of accounting. (Comm. v. Hansen, at al., 360 U.S. 446, 79 S. Ct. 1270 (1959) Ct. D. 1838, 1959-2 C.B. 460.)

(5) Assume the same facts as in the previous example except that the finance company requires a 5 percent reserve based on the customer's unpaid balance to the dealer of $800.

(a) The finance company would make the following entry on its books:

	Debit	Credit
Installment Notes Receivable	$920.00	
Cash		$760.00
Insurance Payable		40.00
Finance charges (deferred income)		64.00
Dealers' reserve holdback		56.00

*Note that the "Dealers' reserve holdback" consists of $16 commissions on the original $80 finance charges and $40 holdback, which is 5% × $800.

(b) The automobile dealer would make the following entry on its books:

	Debit	Credit
Cash	$760.00	
Dealers' reserve holdback	56.00	
Customers account receivable (or contracts in transit)		$800.00
Finance Commission earned (20% × $80.)		16.00

(6) Some dealers may exclude the dealer reserve holdback from all books and records and make a memorandum entry in some other manner. For example, using the facts of our previous case, the dealer would record only $760 received from the finance company plus the $400 down payment, consisting of $100 cash and $300 used automobile, or a total of $1,160, as income instead of the correct sale in the amount of $1,200. (See example in 222.2:(2).) In addition, the dealer's participation or commission in the amount of $16 (20 percent x $80 finance charge) would have been omitted from income.

(7) The agent should check to see that the proper method of reporting income is being

employed. Deferred income accounts in the books of the automobile dealer are usually the biggest "tip off" that income may not be properly reported for Federal income tax purposes. The agent should inspect the monthly statements submitted to the automobile dealer by the various finance companies to see if the proper amounts are included in income. Some automobile dealers may set up a subsidiary finance company and transfer the installment notes to that corporation. The subsidiary corporation will then dispose of the installment notes to a regular outside bank or finance company and incur the various holdbacks. The subsidiary company will not be required to include any dealer reserve holdback in its income because the subsidiary company will elect the cash basis method.

(8) The agent should be on the lookout for this scheme and may be able to allocate the income under IRC 482 to the automobile dealer who is on the accrual basis. IRC 1551 concerning disallowance of surtax exemption and accumulated earnings credit may also apply in some cases.

222.3 *(12-7-76)* 4232.2

Finance Department Income

Dealers establishing their own finance department to handle credit sales, may accrue finance charges ratably over the period of the contract, rather than have the charges taxed in full as of the date of execution of the conditional sales contract. In the event of prepayment by the purchaser, an abatement of finance charges is required by Rev. Rul. 67-316, 1967-2 C.B. 171.

222.4 *(12-7-76)* 4232.2

Customers' Deposits

(1) "Customers' Deposits," a clearing account, is found in the liability accounts of the general ledger. This account should be analyzed if large amounts are recorded in the last month of the year to see if sales have been deferred until the following year. Some sales may have been deferred by showing the money received in this account, and not recording the sale until the following year.

(2) Some automobile dealers are giving credit memorandums and showing the amount of the credit memorandums in this account. The credit memorandums are contingent. For example: A customer buys a new car. As an added incentive, the dealer gives the customer a credit memorandum stating that if he buys another new car from the dealer, he will be given a discount of amount showing in the credit memorandum. The credit memorandum cannot be cashed, traded, sold or otherwise disposed of, and is only good to the person to whom the credit memorandum is issued.

(3) Advance payments relating to sale of goods are governed by Regs. 1.451-5.

222.5 *(12-7-76)* 4232.2

Rebates, Bonuses, Discounts, Holdbacks

(1) Dealers in new automobiles may receive from the manufacturer amounts identified as follows:

(a) sales incentives—rebates given on old models after model change;

(b) bonuses;

(c) rebates for meeting sales quotas;

(d) rebates on advertising expenses;

(e) rebates for parts used in warranty adjustments; and

(f) discounts.

(2) A check should be made to see that the above items have been included in income.

(3) Some manufacturers hold back on discounts and pay them to the dealer after the end of the year. Such an arrangement lends itself to the noninclusion of the discount in income by the dealer.

(4) Most manufacturers now bill their dealers for a flat two percent holdback which is retained until the end of the year and then returned to the dealer. It is merely a deposit required, but some dealers may include the billing in their cost of goods sold during the year and then not include the refund in income.

222.6 *(12-7-76)* 4232.2

Insurance Commissions

Automobile dealers in some states may also act as insurance brokers and, therefore, may have received insurance commission income. In some instances, it may be contrary to local law for an automobile dealer also to be an insurance broker. When the automobile dealer does sell insurance, he/she generally will have an insurance agency through which is issued the customers' automobile insurance coverage. In such cases, the examiner should check for proper reporting of insurance commissions. This can be done by reconciling the figures shown on the "monthly accounts current" with the insurance commissions reported by the broker-dealer. The "monthly accounts current" is a billing furnished to the insurance broker-automobile dealer by the insurance company being represented. The agent should investigate to see if the insurance broker-automobile dealer has another corporation receiving the insurance commissions, or if the officers are receiving insurance commissions personally and not reporting the commissions on the books and records of the business. When applicable, an allocation of the commissions should be made to the taxpayer earning them under IRC 482. This may also result in constructive dividends to the stockholders of this taxpayer.

222.7 *(12-7-76)* 4232.2

Customer Service Contracts

Automobile dealers often sell service policies, lubrication coupon books, guarantee contracts, etc. These proceeds cannot be amortized over the periods to which service is to be rendered, but must be included in income when received or accrued.

222.8 *(12-7-76)* 4232.2

License, Transfer, and Filing Fees

(1) Automobile dealers frequently pay the above fees to state authorities for the car purchaser, but recover such payments through cash receipts or through accounts receivable if the fees are entered on the invoice.

(2) The agent should check to see that the recoupment of these fees is properly controlled and accounted for.

230 *(12-7-76)* 4232.2

Sales of Leased Automobiles

Some automobile dealers also lease automobiles. An automobile leasing agency that customerily engages in selling its automobiles is in the business of dealing in automobiles as well as in the business of leasing them. Depreciation is allowable, but any gain on their sale is ordinary income because they are subsequently held primarily for sale to customers. In this case, the treatment of leased automobiles differs from that of demonstrators in that depreciation is allowable on leased cars before their conversion to property held primarily for sale to customers in the ordinary course of business.

240 *(1-9-76)* 4232.2

Sale of Personal Property

Gain from the sale, exchange, or other disposition of depreciable personal property, including a sale and leaseback transaction, must be reported as ordinary income unless the depreciation on the property attributable to periods after 1961 is less than the gain. In that case, gain to the extent of the depreciation is ordinary income and the balance is treated as IRC 1231 property.

250 *(1-9-76)* 4232.2

Inventories

251 *(1-9-76)* 4232.2

New Automobiles

(1) The dealer usually maintains subsidiary record cards for each automobile purchased. The method of valuing the new automobiles is usually at cost less discounts and subsequent price reductions. The inventory cost of the automobiles should include:

(a) basic car cost;

(b) delivery and drayage, including Federal Excise Tax;

(c) options and accessories;

(d) gas and anti-freeze;

(e) undercoating, wax, polish and two-tone; and

(f) convoy collection charges.

(2) The agent should investigate to see that inventories are valued correctly and that any accessories installed by the dealer are included in the automobile inventory cost. The agent also should check to see if officers of the dealer company have any inventory automobiles assigned for personal use to them or their families which were not deleted from the automobile inventory. This inquiry may lead to additional income to the officers involved. A variation of this is to sell at cost (set up a receivable on company books) and later repurchase at cost to be sold by the dealer.

252 *(1-9-76)* 4232.2

Used Automobiles

(1) It is a common practice for automobile dealers to keep perpetual inventory records—individual inventory sheets for each car bought and sold containing description and miscellaneous data relating thereto.

(2) Each automobile taken in trade or purchased should be valued at the appraised wholesale value less the estimated recondi-

tioning cost or the purchased price, whichever is lower. The account should include the inventory value of all used automobiles including reconditioning charges. Dealers generally rely on wholesale market valuations published in appraisal books, such as the "blue book" issued by the National Automobile Dealers' Association. The amount in excess of the inventory valuation on used automobiles taken in trade on a new or used automobile should be charged to the "over-allowance" account. (See 226.)

(3) The agent should check to see if the dealer values his/her automobiles correctly and see that the reconditioning costs are charged to the inventory account since the valuations established at the time of the trade-in do not include the reconditioning charges. The agent should also check to see that all trade-ins are recorded and not omitted and then later sold and the proceeds pocketed or kept by an officer.

(4) Revenue agents have discovered instances where deductions have been claimed for arbitrary reductions (flat percentage) in inventories with a resulting credit to a reserve for inventory valuation, or a direct credit to the inventory. In the examination of the inventories and reserves, the examiner should be alert for such incorrect practices.

253 *(1-9-76)* 4232.2
Demonstrators

(1) Demonstrator automobiles are placed in demonstration service but are held primarily for sale in the automobile dealer's ordinary course of business. These automobiles are considered to be held in inventory and accordingly no depreciation may be claimed.

(2) The agent should investigate to see that the inventory value assigned is the same value as previously mentioned in the valuing of automobiles.

254 *(1-9-76)* 4232.2
Repossessed Automobiles

(1) The dealer may be required to repossess automobiles from a finance company because the customer did not make the required payments on the installment obligation. In other instances the dealer may repossess an automobile which the dealer is personally financing. In either case the dealer should value the automobile at the repurchase price plus repossession expenses, if any, or the appraised wholesale value less estimated reconditioning expenses, whichever is lower.

(2) The agent should check to see that the proper valuation was used and that the automobile dealer correctly computed his gain or loss on the repossession.

255 *(7-2-80)* 4232.2
Parts Inventories

Inventory of parts can be a significant factor to automobile dealers. Care should be taken to uncover arbitrary write downs of parts for prior years' models.

260 *(1-9-76)* 4232.2
Expenses

261 *(7-2-80)* 4232.2
Car Discount

(1) This account represents the net difference between the established list price of the automobile and the actual amount received for the automobile when the automobile is sold at a discount and no trade-in is involved. The agent should check to see that the discount is not in reality a nondisclosure of a trade-in. If this is the case, the dealer may later sell the trade-in and fail to include the proceeds in income.

(2) This transaction is susceptible to discovery since most dealers enter the sales of new cars in a new car sales journal which contains a column for new car discount. At the end of each month, the total from the car discount sales journal is posted to the ledger account "car discount." Upon analyzing the ledger account, any amounts posted from other books of original entry, principally from the cash disbursement journal, would require further investigation.

(3) Another reason for analyzing the discount account is to determine whether the dealer has issued any payments to third parties and charged the discount account. In one situation, the principal officer of a closely held corporation negotiated with an auto dealer for the purchase of a new car for the corporation. The sale was consummated at the full retail price and the corporation remitted payment in full to the dealer. The dealer then issued a check to the principal officer for the discount normally given to the purchaser of a new car. The officer of the closely held corporation was thus able to siphon taxfree funds from his corporation, in an amount in excess of $1,000. In this case, the amount received by the shareholder was considered a dividend from the corporation and taxed accordingly, and the basis of the car in the hands of the corporation was reduced to the amount determined to have been paid for the car.

262 *(1-9-76)* 4232.2
Overallowances

(1) This account represents the allowance in excess of the appraised value of the used automobile or other asset taken in trade on the sale of a new or used automobile.

(2) The agent should check to see if the appraised valuation represents the estimated wholesale value less estimated reconditioning cost and not an arbitrary method of reducing taxable income by valuing the trade-in below the proper valuation. Since the valuation does not include the estimated reconditioning cost, the agent should check to see that any reconditioning cost subsequently incurred is included in the inventory of the used automobile and not expensed.

263 *(1-9-76)* 4232.2
Bad Debts

263.1 *(1-9-76)* 4232.2
Specific Charge-Off Method

When installment notes held by the finance company become worthless, they are charged on the books of the finance company, against either the dealer's reserve or directly to the automobile dealer. In either case, the loss resulting from the worthless note represents a bad debt to the automobile dealer. However, the dealer must prove that such accounts are worthless to him. The action of the finance company is not necessarily final in such a determination.

263.2 *(10-26-87)* 4232.2
Reserve Method

(1) When the dealer does his/her own financing and is on the bad debt reserve method, he/she is entitled to deduct yearly a reasonable addition to the reserve for bad debts under the provisions of IRC 166(c), as determined from his/her bad debt experience.

(2) IRC 166(g) provides that a taxpayer who is a dealer in property may take income tax deductions for reasonable additions to a reserve for bad debts for certain guaranteed debt obligations. These are debt obligations arising out of the sale by the dealer of real or tangible personal property (including related services) in the ordinary course of his/her business on which the dealer becomes contingently liable as a guarantor, endorser or indemnitor to a lender or other person. If a dealer maintains a reserve for guaranteed debt obligations, it must be kept separate from his/her IRC 166(c) reserve.

(3) Examiners have noted instances where automobile dealers have taken repossessed cars into inventory at less than fair market value. The effect of this action is to inflate bad debts (losses on repossession), resulting in a fictitious bad debt loss experience on which the yearly additions to the reserve are based. Thus the true losses are in reality much lower than the alleged "experience" indicates. It would therefore follow that reasonable and justifiable additions to the reserve should be lower than the additions resulting from this erroneous practice.

(4) For tax years beginning after December 31, 1986, the bad debt reserve method was repealed for all taxpayers except commercial banks whose assets do not exceed $500 million, and thrift institutions. Taxpayers (other than certain financial institutions) are required to use the specific charge-off method in accounting for losses on bad debts. Refer to IRC 166 for additional information.

264 *(1-9-76)* 4232.2
Salesmen's Commissions

(1) The agent may find it desirable to analyze the salesmen's commission accounts in comparison with actual sales and commission agreements. If no taxes were withheld from salesmen's commissions (payroll taxes should

be withheld where the salesmen are employees of the dealer), the Forms 1099 covering the commissions should be reviewed.

(2) Total commissions should be reconciled to Forms 1099 and Forms W-2.

265 (1-9-76) 4232.2
Depreciation on Demonstrators and Company Cars

(1) An automobile dealer each year assigns automobiles from his new car inventory to his new car salesmen and company officials. The automobiles are used by these individuals for display and demonstration. Regardless of the length of time the automobiles are used by these individuals, they are not considered property used in business; they cannot be depreciated; and any gain on their sale is ordinary income because they are held primarily for sale to customers.

(2) Employees, other than officers of the corporation, sometimes receive as additional compensation, automobiles for their personal use. Employees could have additional income from these transactions, but the individual circumstances vary.

(3) A list of the names of persons issued demonstrators should be checked against the payroll records to determine if members of the officers' families are using cars and receiving operating expenses for them out of corporate funds. If there is no business purpose for this practice, value received would be taxable income to officer-stockholders under many circumstances

266 (5-30-79) 4232.2
Facilities Lease Rental

(1) In many instances, auto dealerships are corporations and lease their facilities from their stockholders. In some instances, these lease arrangements are not at arm's-length and are often drawn on a "per-unit-sold" basis. More often than not, such rents do not represent a fair and reasonable amount on a comparable basis.

(2) When the examiner questions the resulting rental payments, the dealership can usually show statistical information, compiled by the auto manufacturer, which indicates such rentals are not excessive. Since these statistics contain data which is not at arm's-length, they should not be relied upon to determine the fair rental value of such a facility.

(3) Fair rental value should be determined by using comparable values in the immediate area of the dealership. Such values are usually stated on the basis of dollars per square foot of space.

(4) The difference between the fair rental value and the amount paid is usually construed to be a constructive dividend to the shareholders. In some instances, this difference is allocated among or between taxpayers consistent with IRC 482.

Chapter 300

Mobile Home Dealers

310 (12-7-76) 4232.2
General

(1) The mobile home dealer's business may vary from the limited field of selling only mobile homes, to a wide variety of other services such as rentals and insurance. In most instances, however, you will find mobile home dealers engaging in new and used mobile home sales, accessory and replacement part sales and service, and repair work. Most dealers are "franchise" dealers for at least three or four different manufacturers. A few of these manufacturers will place their units on a dealer's lot on consignment, but usually most units on a dealer's lot are there under "floor plan" financing. A high percentage of mobile home sales are under "conditional sales contracts" and, for the most part, are financed by banks and finance companies specializing in the field. These contracts are for varying periods of time ranging from 2 years to 7 years with the majority in the 3-year to 5-year category.

(2) Accounting records and practices of mobile home dealers are similar in many respects to those of automobile dealers. You will find, however, a common lack of uniformity in the type of records used since mobile home dealers do not have the dealer manuals and prescribed records such as those used by most dealers in new automobiles. The records of the various dealers will naturally be similar, but you will find differences depending on the individual operation and what each dealer deems adequate. For the most part, you will find mobile home dealers using some form of combined cash journal and a general ledger.

320 (12-7-76) 4232.2
Income

321 (12-7-76) 4232.2
Introduction

The sources of income in the mobile home area will vary with each dealer depending somewhat on the size and scope of the business. There are items of income that invariably occur in the normal course of mobile home sales. You will recognize these as you proceed through the various items of income that you are likely to encounter.

322 (12-7-76) 4232.2
Sale of New and Used Mobile Homes

Generally the method of recording these sales is much the same as practices followed in any other retail business. The majority of these sales will be made under conditional sales contracts secured by a chattel mortgage. These contracts are normally sold by the mobile home dealer to a finance company. A part of the proceeds is usually held in reserve by the finance company to ensure against losses. You will find some dealers financing a part or all of their own sales. However, this is not the rule and when it does exist, it usually is confined to used mobile homes since a smaller amount of financing is involved. A typical mobile home sale is illustrated by the following entries:

Sales Invoice of the Mobile Home Dealer

51 Blue Water #3003	$5,495.00
Less Trade-in, 1948 Overland	800.00
To be financed	$4,695.00

Book Entry to Record Sale on Books of Mobile Home Dealer

Purchases	$ 800.00	
Accounts Receivable	4,695.00	
Sales		$5,495.00

Book Entry—Contract, Books of Mobile Home Dealer

Dealer-Held Reserve	$ 135.00	
Cash: Finance Co. Check	4,540.00	
Intangible Tax	20.00	
Accounts Receivable		4,695.00

323 (12-7-76) 4232.2
Trade-Ins

Mobile home dealers are prone to accept various items of real and personal property in trade as down payment or partial down payment on the sale of mobile homes. Included in these items are such things as automobiles, boats, household goods, jewelry, unimproved real property, and low-priced improved real property. The recording of the sale of these items is no different from that in any other business, but you should be cognizant that this situation exists since it is a widespread practice and an area where property may be appropriated for personal use, or sales of such assets omitted from income.

324 (12-7-76) 4232.2
Finance Income

324.1 (12-7-76) 4232.2
General

(1) You should become familiar with the mobile home dealer's finance arrangements and the agreements that exist between the dealer and the various finance companies with whom the dealer conducts business. Illustrated below are pertinent excerpts from a typical agreement regarding finance reserves and income.

(a) "The purchase price of each contract purchased by and assigned to the finance company hereunder shall be equal to 95% of the aggregate of the retail cash sales price of the mobile home and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance."

(b) "An amount to be determined by the finance company from time to time in its absolute discretion equal to not more than 8% of the aggregate of the retail cash sales price of the mobile home and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance will be credited by the company to a special reserve account in the name of the Dealer hereunder as to each contract purchased by and assigned to the company hereunder, which account will be referred to as the 'Dealer Reserve Account.' In addition, the company may credit to such Dealer Reserve Account hereunder, but shall not be obligated so to do, one-fifth (1/5) on new trailers and one-sixth (1/6) on used trailers, or such other portions as the company may determine from time to time, of the finance charge paid or agreed to be paid by the purchaser in each contract. In addition to and without affecting any or all of its rights hereunder, the company may, at its own option, charge against the Dealer Reserve Account any sums that the Dealer may at any time owe to the company in any connection whatsoever. In the event and at such time or times as the Dealer Reserve Account shall exceed 15% of the aggregate unpaid balances of all contracts purchased by and assigned to the company hereunder by the Dealer plus all contingent liabilities which, on the sole determination of the company, it may have with respect to such contracts, the company will pay such excess to the Dealers from time to time as determined by the company but not more frequently than once each month. In the event that and at such time as all contracts as shall have been purchased and assigned to the company by the Dealer shall have been paid in full and no sums shall remain unpaid thereunder and in the opinion of the company there shall be no contingent liability on the part of the company with relation thereto, the company shall pay to the Dealer the balance of the credit in such Dealer Reserve Account. The company's determination as to the possibility of contingent liability shall be final and not subject to question by the Dealer."

324.2 *(12-7-76)* 4232.2
Dealer Participation Reserve

(1) The finance income of the mobile home dealer will arise primarily from what is commonly known in the trade as a "dealer participation reserve." This is a portion of the finance income to be earned by the finance company which is set aside in a reserve account on the books of the finance company and should be carried as a receivable on the books of the dealer. Dealers do not always record this receivable on their records and may only record the income when it is available in cash, or, in instances where the receivable is recorded properly, the corresponding credit may be recorded as a deferred income item. Both methods are erroneous since the courts have held that this reserve credit represents income to the dealer at the time it is credited to the reserve account on the records of the finance company. In this connection you should familiarize yourself with the provision of IRC 481, relating to changes of accounting methods.

(2) You should also be familiar with the Dealer Reserve Act of 1960, relating to elections available to dealers which will distribute the tax impact of accounting for accumulated reserves not previously reported as income. Since the reserve issue is present in areas heretofore discussed, a lengthy discussion of the mechanics of the reserve is not warranted here. It is sufficient to say that these reserve credits are computed on the basis of either a written or oral agreement between the dealer and the finance company and the amount may be determined as a percentage of the contract, percentage of the finance charges, or a flat sum per contract. It is important to remember that the mobile home dealer usually is not required to do all his/her financing with one company and thus he may have more than one reserve account. In addition, many of the so-called independent financing deals with local financial institutions may result in reserves for the benefit of the dealer.

(3) There are at least two other reserve accounts you are likely to encounter. These technically are not finance income reserves. These accounts do not result in income since they represent a "holdback" or advance of funds due the dealer. They are however, directly related to the dealer's financing arrangements. The first of these reserves is commonly known in the trade as a "holdback reserve." Very often the written or oral agreements heretofore mentioned contain a provision whereby the finance company acquires a conditional sales contract from the dealer at a stipulated percentage of the face value. This fixed percentage varies somewhat but is usually 95 to 97 percent of the unpaid balance due on the contract. The difference between the stipulated percentage and the face value is credited to the dealers hold back reserve account on the books of the finance company and represents a receivable to the dealer. Such amounts subsequently are paid to the dealer at various times according to the terms of the respective agreements. If the original sale was properly reported in the full amount, this reserve would have no affect on income (refer to the sales illustrations in 322). You should check, however, to see that the sale has not been netted out by deducting from sales the fixed percentage withheld by the finance company and reporting only the difference as income. The problem normally encountered in such cases is where the dealer sometime later in the tax year seeks a deduction in some manner to the extent of the increase in this reserve during the year. This sought-after deduction may take many forms, some of which are: a direct charge to sales, a charge to cost of sales, or a charge to bad debts with a credit to a deferred income account or a similar credit entry.

(4) The second of these reserves is known as a "special holdback reserve" or "due bill," depending upon whether the funds involved are withheld by the finance company from the proceeds due the dealer on sales contracts or are an actual advance of funds from the dealer to the finance company. The finance company usually requires a stipulated amount of down payment by a purchaser of a mobile home. On any deal when the finance company believes a down payment is inadequate, the finance company may withhold an additional sum from the amounts otherwise paid the dealer. This withheld amount is held in a reserve account or the dealer may be required to advance funds sufficient to cover the so-called "short" down payment. These funds are released to the dealer when the balance due on the contract reaches what the finance company feels is a safe level. Such items have nothing to do with the selling price of a mobile home and will not affect income of the dealer unless a deduction is sought in much the same manner as outlined in the discussion regarding the first "holdback" reserve. The deduction when it is sought usually takes the same form as previously mentioned.

325 *(12-7-76)* 4232.2
Manufacturer's Bonus

(1) This bonus poses no particular problem but you need to be aware that it may exist in order to properly determine that all sources of income have been reported by the dealer. This bonus is paid by some mobile home manufacturers as an incentive to the dealer to put forth extra effort in selling a particular make of mobile home. This bonus normally is a flat amount for each unit sold.

(2) In addition to the flat amount for each unit sold, many dealers have a quantity discount agreement computed on a bonus year different from their taxable year and based on a graduated percentage scale as total sales increase. Accrual-basis dealers should accrue the earned portion of this type of bonus and include it in taxable income during the period earned, rather than waiting for the actual cash payment.

326 *(12-7-76)* 4232.2
Insurance Commissions

Some mobile home dealers also are insurance brokers and their records should disclose insurance commissions. The insurance broker-mobile home dealer normally will not write insurance on units financed with the major financial institutions. These organizations usually have their own insurance package which is a part of the conditional sales contract. Insurance sold by the dealer normally will relate to units sold for cash or under independent financing arrangements.

327 *(12-7-76)* 4232.2
Rentals

(1) Some mobile home dealers also operate or have an interest in a mobile home part in conjunction with their sales operation, or otherwise have access to property suitable for parking mobile homes. In this situation you may find the dealer placing mobile homes from his/her inventory, particularly used mobile homes, on these parking areas and deriving rental income which is not reported or is reported improperly.

(2) In some jurisdictions mobile home park operators collect a license fee for each site rented and remit it to the tax collector of the city or town where the trailers are located. Based on the license fee charged per trailer, per month, as determined from official records, together with the rental charges per trailer, estimated gross rental receipts may be computed. Another method of determining gross receipts is through the local Health Department records of trailers inspected. Multiply the number of trailers occupied by the rental charged per month.

328 *(12-7-76)* 4232.2
Audit Checkpoints

(1) Most of the usual audit checkpoints for testing the accuracy of income reporting by any retail business also are applicable to the mobile home dealers area and need not be repeated here. However, some specific checkpoints with which you should be familiar are as follows:

(a) A valuable preliminary checkpoint

which will acquaint you with some of the items you may encounter when you start your audit is the city directory or the classified section of the telephone directory. Advertisements in these directories frequently will give you a brief resume of a particular dealer's business. These advertisements show such things as the broad names of mobile homes for which the dealer has a franchise, brand names of accessory and replacement parts handled, information regarding service, and financing and insurance arrangements.

(b) Each mobile home bears a manufacturer's serial number. This number can be used to trace and cross-check from purchase invoices and inventory cards to sales invoices and conditional sales contracts, to check selling prices recorded on sales invoices against the selling prices on conditional sales contracts, and to trace used trailers acquired as trade-in property through sales and inventory accounts.

(c) A method of verifying sales can be developed by checking title registrations of mobile homes with the State registrar and in some cases sales tax data can be utilized where such tax is applicable.

(d) Many dealers maintain a folder on each unit sold, particularly on mobile homes which are financed. This folder will normally disclose any items of personal or real property received as a trade-in. These items should be checked through the sales and inventory accounts. When this folder does not exist, trade-in items frequently are shown on the sales invoice of the mobile home unit sold.

(e) Proper accounting for the various finance company reserves can be verified by reference to the agreements existing between the dealer and the finance company and a study of the dealer's books and records. These agreements often will disclose the number of reserves which may be present. If there is reason to believe that the dealer does business with more than one finance company, a check of conditional sales contracts should reveal the names of these financial institutions. It is usual for finance companies to periodically furnish dealers with transcripts of their reserve accounts and these transcripts can be checked against book entries.

330 *(12-7-76)* 4232.2
Cost of Sales

331 *(12-7-76)* 4232.2
General

Items making up the cost of sales of the mobile home dealer probably will vary rather widely depending on the particular operation of each dealer. For the most part, however, in addition to sales of new and used mobile homes, typical operations include sales of mobile home accessories and repair parts. As has been indicated, many dealers take various items of real and personal property as down payment on mobile homes sold.

332 *(12-7-76)* 4232.2
New and Used Mobile Homes Inventories

(1) Mobile home dealers use both cost and the lower-of-cost-or-market methods of valuing inventories. The cost method is most prevalent among smaller dealers while the lower-of-cost-or-market is most prevalent among larger dealers. The cost method normally entails nothing more than the recording of new units at their actual cost and used units received as trade-ins at the amount allowed the buyer on the trade. This practice in some instances distorts income since there often is a trade-in over allowance factor involved which may cause the trade-in unit to be valued at a cost price in excess of its eventual selling price.

(2) The use of the lower-of-cost-or-market method normally entails the use of the so-called "blue book" value, which is the current value of a mobile home as shown by the National Used Trailer Report, or similar publication. This method is often used with an overallowance or discount account on the books of the mobile home dealer. A mobile home taken in trade will be written down to "blue book" value at the time taken in. The excess, which is the difference between the amount allowed on the trade and the current blue book value, will be reflected in the over-allowance or discount account. All mobile homes on hand at the end of the dealer's tax year will be adjusted to market values existing at the end of such year as reflected by the "blue book."

333 *(12-7-76)* 4232.2
Accessories and Repair Parts Inventories

(1) The accessory and repair parts portion of the dealers inventory normally poses no particular problem since it is usually valued at cost. It is considered sufficient that you be aware of the fact that these items are includible in inventory by the dealer.

(2) Because of a customer's preference, sometimes furnished mobile homes or trailers are sold unfurnished. Obviously, this factor should be reflected in the cost of goods sold section. Transactions covering specific sales of unfurnished trailers may be checked to verify that cost of furniture and other furnishings have not been included. Such furnishings removed by the dealer should be reflected in inventory accounts, or sales accounts if sold separately.

334 *(12-7-76)* 4232.2
Miscellaneous Property

This miscellaneous property area is quite common among mobile home dealers. Dealers often will accept a wide variety of personal and/or real property as down payment or partial down payment on the sale of a mobile home. Some of the more common items that you may encounter in this category are automobiles, furniture, jewelry, vacant lots and low-priced improved real estate. This brief list is by no means all-inclusive. Mobile home dealers are known as "traders" and have been known to accept such items as firearms, livestock, boats and mink coats. It is reasonable to expect that you might find mobile home dealers accepting almost anything of value as a down payment or partial down payment on a sale. Where the dealer uses the lower-of-cost-or-market method of valuing inventories, these miscellaneous items pose a valuation problem. You should be aware that this is an area where many dealers are prone to omit miscellaneous trade-in items from inventory.

335 *(12-7-76)* 4232.2
Reconditioning Costs

Verification of reconditioning costs presents no unusual problems and there is no need for detailed discussion in this area. These are nothing more than general repair and replacement of worn parts or furnishings deemed necessary to effect the sale of used mobile homes and should be charged to the cost of such mobile homes.

336 *(12-7-76)* 4232.2
Audit Checkpoints

(1) The task of verifying the accuracy of inventories and cost of sales of the mobile home dealer is not substantially different from methods used in checking the listings, extensions, pricing, valuations and purchases of other retail businesses. The most important thing is that you be aware of the usual sources of information which can be cross-checked in verifying the cost of sales items. Some of these are listed below.

(a) New mobile homes may be checked by taking the purchase invoices of the dealer for the latter months of the accounting period and cross-checking these against the dealer sales invoices and the inventory sheets by manufacturer's serial number to determine if all new units are either reported as sold or included in inventory.

(b) Used mobile homes may be checked by reviewing the sales invoices, conditional sales contracts and purchase records for a selected period near the end of the accounting period and finding the description or serial number of used units taken in trade, and checking these against sales records and inventory sheets. In checking both used and new mobile home units, the previously cited individual folders maintained by many dealers containing all the pertinent papers concerning individual sales are a valuable source of information.

(c) Miscellaneous real and personal property will, of course, be the most difficult item to check. Here again, normally the sales invoice, conditional sales contract, sales journal and individual unit folders, will contain a description of the property taken in trade. This can be checked against subsequent sales and inventory sheets. When there is reason to believe that real property is involved you can, of course, check the public records where such transfers of property are normally recorded.

340 *(12-7-76)* 4232.2
Expenses

341 *(12-7-76)* 4232.2
General

Basically, all the expense items found in the records of both automobile and mobile home dealers are quite similar to other retail businesses. Most of the expense categories that commonly are problem areas in other businesses also may be found in mobile home businesses. These are areas where you will employ normal audit techniques and sound judgment in developing issues. Nevertheless, it is suggested that you give close scrutiny to the sales promotion and advertising accounts, particularly with the larger automobile dealer concerns. It has been found that in some instances substantial bonuses have been paid to the salesman for meeting certain sales quotas. Of particular concern is that often the bonuses are paid in the form of vacation trips, prizes, etc. If such is the case, you should satisfy yourself that the amount claimed as an expense by payor-dealer is correct. In addition, depending upon your judgment and the particular facts involved, you may deem it necessary to requisition the returns of the salesmen who received the bonuses.

342 *(12-7-76)* 4232.2

Write-Offs of Loans or Investments

Some mobile home dealers also have an interest in a mobile home manufacturing concern. The dealer may attempt to write off his/her "loan" or investment in the manufacturing concern by maintaining that his/her advances are in the nature of research and development expenses. The write-off is accomplished by either a direct write-off to expense or by understating the ending inventory of the mobile home purchased from the manufacturer.

343 *(12-7-76)* 4232.2

Bad Debts

343.1 *(12-7-76)* 4232.2

Specific Charge-Off Method

When installment notes held by the finance company become worthless, they are charged on the books of the finance company against either the dealer's reserve or directly to the dealer. In either case, the loss resulting from the worthless note represents a bad debt to the dealer. However, the dealer must prove that such accounts are worthless to him/her. The action of the finance company is not necessarily final in such a determination.

343.2 *(12-7-76)* 4232.2

Reserve Method

(1) When the dealer does his/her own financing and is on the bad debt reserve method, he/she is entitled to deduct yearly a reasonable addition to the reserve for bad debts under the provisions of IRC 166(c), as determined from its bad debt experience.

(2) IRC 166(g) provides that a taxpayer who is a dealer in property may take income tax deductions for reasonable additions to a reserve for bad debts for certain guaranteed debt obligations. These are debt obligations arising out of the sale by the dealer of real or tangible personal property (including related services) in the ordinary course of his/her business on which the dealer becomes contingently liable as a guarantor, endorser or indemnitor to a lender or other person. If a dealer maintains a reserve for guaranteed debt obligations, it must be kept separate from his/her IRC 166(c) reserve.

350 *(12-7-76)* 4232.2

Balance Sheet

(1) For the most part the various asset, liability and capital accounts of the automobile and/or mobile home dealer will compare with the accounts that you normally encounter in the audit of a retail business. A possible exception to this rule is that you will or should find the receivables from the finance company in the asset section of the dealer's balance sheet.

(2) If a dealer is not properly accounting for reserve credits, you may find a deferred income account in the liability section of the dealer's balance sheet. You should check the closing out of these deferred income accounts and any unexplained credits to retained earnings or surplus. It has been noted that with the taxability of these reserve credits established by the Supreme Court (Comm. v. Hansen, supra), some dealers are changing to the proper method of reporting in current years, but in the process are closing their prior year accumulations by credits to surplus in an attempt to avoid the payment of tax on these prior year reserve credits that have accumulated.

EXHIBIT 9.910 REFERENCE SOURCES

This exhibit provides a listing of tax court cases, IRS announcements, Treasury Decisions (T.D.), revenue rulings, revenue procedures and private letter rulings (PLR) which directly and indirectly pertain to tax issues affecting auto dealerships.

Court Cases

Adams Motor Co. (1926) 4 BTA 589(A)
Aaron Mosko, TC Memo 1986-447; IRC Secs. 162, 264, 6653, 1301.
Albert L. East III, TC Memo 1989-658; IRC Sec. 215.
AMERICAN PROPERTIES, INC., 28 TC 1100.
Andrew L. Collins, TC Memo 1990-441; IRC Secs. 170, 6653.
Anna Mae Trohimovich, TC Memo 1991-323.
Arlan L. Robinson, TC Memo 1990-235; IRC Secs. 446, 6501, 6653, 6013.
Arthur S. Janpol, 101 TC 518; IRC Sec. 4975.
Automotive Investment Development, Inc., TC Memo 1993-298; IRC Sec. 162.
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PLR 9522022, IRC Sec. 471
PLR 9525003, IRC Sec. 3121
PLR 9535009, IRC Sec. 472
PLR 9535010, IRC Sec. 472

CHAPTER 10

COMPLETING THE AUDIT

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CHAPTER 10

COMPLETING THE AUDIT

10.000 INTRODUCTION

10.001 Completing the audit is often the most critical, yet most underestimated, phase of the audit in terms of the amount of time required and its importance to meeting the audit objectives. Good engagement "wrap-up" involves more than just the administrative tasks that first come to mind; it requires summarizing and evaluating audit findings, determining that the proper opinion and other reports are issued, performing a final review of the financial statements, and ensuring that the audit procedures and working papers conform with authoritative standards, as well as the firm's quality control policies and procedures.

10.002 The procedures involved in completing the audit should include:

- Performing final analytical procedures.
- Obtaining legal letters.
- Performing subsequent events procedures.
- Summarizing and evaluating possible journal entries.
- Obtaining written management representations.
- Communicating to the dealership:
  - errors and irregularities.
  - illegal acts.
  - reportable conditions.
  - certain other matters (if Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees*, applies to the dealership).
- Completing the review of assistants' work.
- Preparing financial statements and auditor's reports.
- Consulting with others in resolving certain issues.
- Completing performance appraisals and final time summary.

10.003 Except for completing performance appraisals and final time summary, these procedures should be performed before engagement personnel leave the client's offices. The procedures and the applicable authoritative literature are discussed in the following sections.

10.100 ANALYTICAL PROCEDURES

10.101 As discussed in Chapter 4, analytical procedures are required to be performed in planning the nature, timing, and extent of auditing procedures. Chapter 7 discusses how analytical procedures are used as substantive tests to obtain evidential matter about particular assertions related to account balances and classes of transactions.

10.102 SAS No. 56, *Analytical Procedures* (AU 329.04), also requires the use of analytical procedures "as an overall review of the financial information in the final review stage of the audit." Paragraph 22 of SAS No. 56 (AU 329.22) states:

> The objective of analytical procedures used in the overall review stage of the audit is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation.

10.103 Overall review procedures generally include reading the financial statements and notes and considering:

- Whether evidence gathered during the audit as to unusual or unexpected balances was adequate, and
- Whether there are any unusual or unexpected balances or relationships not previously identified.

The results of these procedures may require the auditor to perform additional tests.

10.104 Overall review analytical procedures may also involve comparisons of recorded amounts to financial information for comparable prior period(s) and industry data. If the results of the overall review indicate that additional procedures must be performed, the authors recommend that such procedures be documented in a separate memo or working paper.

10.105 The review should be performed by someone familiar with all aspects of the engagement; generally, they are performed by the in-charge. However, the engagement partner may be in a better position to provide a critical and objective review of the financial presentation.

10.106 The Engagement Performance Review Checklist at section 10.908 contains a step that requires performance of the overall review. The Worksheet for Overall Review Analytical Procedures, included in section 10.910, should be used in performing this overall review.

10.200 OBTAINING LEGAL LETTERS

10.201 SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU 337), provides guidance to the auditor in (1) identifying litigation, claims, and assessments, (2) determining that such matters are appropriately reflected in the financial statements, and (3) issuing the appropriate auditor's report.

10.202 The auditor's procedures for identifying litigation, claims, and assessments should include:

- Inquiring of and discussing with management the policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the balance-sheet date and up to the date the information is furnished (which should be the auditor's report date), including matters referred to legal counsel, and assurance from management that all matters required to be disclosed by Statement of Financial Accounting Standards (SFAS No. 5), *Accounting for Contingencies*, have been disclosed.
- Examining the client's documents concerning litigation, claims, and assessments.
- Obtaining assurance from management that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with SFAS No. 5. (This assurance is generally stated in the client's letter of inquiry to the lawyers.)

10.203 The auditor should be aware that certain other procedures performed for different purposes may also uncover litigation, claims, and assessments, including:

- Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited.
- Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents.
- Obtaining information concerning guarantees from bank confirmation forms.
- Inspecting other documents for possible guarantees by the client.

10.204 A letter of inquiry to the client's legal counsel is the auditor's primary means of obtaining corroborating evidence of the information provided by management about litigation, claims, and assessments. This letter of inquiry and the lawyers' responses are so important that the client's refusal to send the letter or the lawyer's refusal to respond fully would be considered a limitation on the scope of the audit.

10.205 Letters should be sent to all lawyers who devoted substantive attention on behalf of the client to pending or threatened litigation and asserted or unasserted claims and assessments in the form of legal consultation or representation. A review of the client's correspondence with its lawyers, the lawyers' billings for services, and prior year's working papers are good sources of information for identifying the lawyers to whom letters of inquiry should be sent.

10.206 SAS No. 12 (AU 337.09) lists the following matters that should be covered in the letter of inquiry:

a. Identification of the dealership, including subsidiaries, and the date of the audit.

b. A list prepared by management (or a request that the lawyer prepare the list) that describes and evaluates pending or threatened litigation, claims, and assessments that the lawyer has been engaged to handle, and to which the lawyer has devoted substantial attention on behalf of the dealership.

c. A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome and to which the lawyer has devoted substantial attention on behalf of the dealership.

d. As to each matter in item b., a request that the lawyer either furnish the following or comment on matters as to which his or her views may differ from those stated by management:

   (1) A description of the nature of the matter, the progress of the case to date, and the action the dealership intends to take.

   (2) An evaluation of the likelihood of an unfavorable outcome and an estimate, if possible, of the amount or range of potential loss.

   (3) With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

e. As to each matter in item c., a request that the lawyer comment on those matters to which his or her views about the description or evaluation of the matter differ from those stated by management.

f. A statement by management that they understand that whenever, in the course of performing legal services regarding a matter recognized to involve an unasserted possible claim or assessment that may require financial statement disclosure, the lawyer has formed a professional conclusion that management should disclose or consider disclosing the possible claim or assessment, the lawyer will so advise management and consult with management about the disclosure and applicable requirements of SFAS No. 5.

g. A request that the lawyer confirm whether the understanding described in item f. is correct.

h. A request that the lawyer specifically identify the nature of and reasons for any limitations on his or her response.

Other Considerations in the Letter

10.207 Immaterial Matters. To avoid requiring the lawyer to respond to clearly immaterial matters, many auditors will have the client include in the letter of inquiry an instruction that the lawyer need address only matters exceeding a specified dollar amount. This amount should be mutually agreed upon by the client and the auditor.

10.208 Timing of Letter and Response. Generally, letters of inquiry are sent at the beginning of year-end field work to give the lawyers adequate time to respond. Many auditors have the client specify the date of the lawyer's response, because AU Section 560, *Subsequent Events*, requires the auditor to inquire of the client's lawyer about litigation, claims, and assessments for the period from the balance-sheet date through the date of the auditor's report, which is generally the date of completion of field work. The specified date is generally slightly before the completion of field work to allow the auditor adequate time to evaluate the responses. As a practical matter, if the lawyer's response is dated more than two weeks before the completion of field work, the auditor may decide to obtain an oral update directly from the lawyer. The results of this oral response should be documented.

10.209 Request for Unpaid and Unbilled Fees. To obtain information about unrecorded liabilities, many auditors have the client include a request that the lawyer indicate the amount of any unpaid or unbilled fees as of the balance-sheet date.

10.210 If the auditor becomes aware that the client's lawyers have resigned or have been changed either during the year or subsequent to year-end, the auditor should inquire as to the reasons for the resignation or change.

10.211 The in-charge and partner should carefully read and evaluate responses to determine that all significant litigation, claims, and assessments have been properly accounted for and disclosed, and to identify any limitations of the response, either expressly or by omission. Conclusions should be documented by the in-charge and reviewed by the partner. Illustrative inquiry letters to legal counsel are included in sections 10.901 and 10.902.

10.300 SUBSEQUENT EVENTS

10.301 Completing the audit includes performing certain procedures to identify whether any events have occurred since the balance-sheet date that would require adjustment to or disclosure in the financial statements. AU Section 560, *Subsequent Events* (AU 560.12), states:

> The independent auditor should perform other auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements. . . . These procedures should be performed at or near the completion of the field work.

10.302 Procedures the auditor should perform to identify and evaluate subsequent events include:

- Read the latest available interim financial statements, compare them with the financial statements being reported upon, and make any other comparisons considered necessary. The auditor should determine whether the interim statements have been prepared on the same basis as that used for the audited financial statements.
- Inquire of and discuss with officers and other executives having responsibility for financial and accounting matters as to:
  - The existence of any substantial contingent liabilities or commitments at the balance-sheet date or at the date of inquiry.
  - Any significant changes in the capital stock, long-term debt, or working capital that have occurred up to the date of inquiry.
  - The current status of items that were accounted for on the basis of tentative, preliminary, or inconclusive data.
  - Any unusual adjustments made during the period from the balance-sheet date to the date of inquiry.

- Read the available minutes of meetings of stockholders, directors, and appropriate committees.
- Inquire of the dealership's legal counsel concerning litigation, claims, and assessments.
- Obtain a representation letter from the client that includes a statement about whether any events have occurred subsequent to the balance-sheet date that, in the client's opinion, would require adjustment to or disclosure in the financial statements.
- Make any other inquiries or perform other procedures considered necessary to dispose of questions that arise in carrying out the above procedures.

10.303 To document performance of these procedures, the Subsequent Events Review Program included in section 10.903 should be completed.

10.400 SUMMARY OF POSSIBLE JOURNAL ENTRIES

10.401 SAS No. 22, *Planning and Supervision* (AU 311), requires the consideration of an overall materiality limit during planning. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU 312), requires the subsequent evaluation of misstatements by comparing the known, but unadjusted, and the estimated or projected misstatements, to the overall materiality limit. Auditors should think of materiality as a constantly evolving benchmark, rather than as a fixed amount calculated at the beginning of the engagement and carried through to its completion. Materiality thresholds should be revised as necessary in light of new information that arises during the course of the audit, and as the context in which it is used changes.

10.402 The Summary of Possible Journal Entries Form in section 10.904 is designed so that the auditor can subjectively consider whether the effects of possible journal entries are material to the financial statements as a whole.

10.403 The following types of misstatements should be included in the Summary of Possible Journal Entries Form:

- Known but unadjusted misstatements.
- Projected misstatements from sampling applications.
- Estimated misstatements from predictive analytical procedures.

Misstatements From the Prior Year

10.404 Often overlooked is the consideration of misstatements detected in the prior year that affect the current year. For example, assume last year's Summary of Possible Journal Entries Form included an item representing a $500 overstatement of prepaid insurance and an understatement of insurance expense. This item should also be posted to the current year's form because it affects the current year's insurance expense. Therefore, the prior year's Summary of Possible Journal Entries Form should be reviewed for any items that may have an effect on the current year's financial statements, and such items should be posted to the current year's form.

Practice Tip:

In considering the effects of prior year's possible journal entries on the current year's financial statements, be alert for items that carry over and accumulate from year to year, such as an understatement of the prior year's allowance for bad debts of $10,000 that has increased to $15,000 in the current year. Even though such misstatements may be immaterial to the current and prior year's income statements and balance sheets, the authors recommend that you urge your clients to correct such misstatements before they become material.

Establishing Thresholds for Posting Unadjusted Misstatements

10.405 Some firms establish a predetermined dollar threshold above which misstatements should be recorded as adjusting entries, and below which misstatements should be posted to the Summary of Possible Journal Entries Form as unadjusted misstatements. Often such a threshold results from the client's desire to record all misstatements detected during the audit that exceed a certain dollar amount. Other firms prefer to not establish such a threshold because they believe this decision should be based on the nature or sensitivity of the accounts affected by the misstatement.

10.406 To avoid posting clearly inconsequential misstatements, many firms also establish a threshold below which items are not to be posted to the Summary of Possible Journal Entries Form. In other words, they establish a minimum dollar amount that a misstatement must exceed to qualify for posting to the Summary. For example, if this minimum amount were $10.00, and a $9.00 misstatement is detected in cash, the misstatement would be noted in the cash workpapers, but not posted to the Summary of Possible Journal Entries Form. This process can often save valuable engagement time.

Using the Summary

10.407 The Summary of Possible Journal Entries Form should be prepared for all audit engagements by the in-charge and reviewed by the engagement partner.

Practice Tip:

Because professional judgment is needed to assess materiality and the effects that misstatements have on the financial statements, it is very important that the engagement partner participate in completing the Form. The partner therefore, should review each proposed journal entry, as well as the final conclusion.

10.408 The overall materiality limit obtained from the Materiality Computation Form (Chapter 4, section 4.507) should be indicated in the space provided. Also, the dollar value over which misstatements should be posted to the Form should be indicated in the space provided.

10.409 The Summary of Possible Journal Entries Form has been designed to permit the evaluation of the effect of unrecorded misstatements on both the financial statements taken as a whole and on key components of the financial statements.

10.410 The Form is designed to permit easy evaluation of misstatements in key components of the financial statements, such as current and noncurrent assets, current and noncurrent liabilities, stockholders' equity, and the income statement. Misstatements should be posted to the Form in the appropriate columns (for Lotus 1-2-3 formulas, debits should be positive amounts and credits should be negative amounts).

10.411 Misstatements affecting the income statement are further broken down into three categories: known, estimated, and projected. "Known" misstatements are those for which the amount of the error is relatively certain. Such misstatements are often supported by highly reliable evidence, such as third-party documents. An example of a known misstatement would be a failure to record an invoice for repairs expense. Such an item would be posted to the Form as a debit (positive amount) in the "Known Misstatements" column and a credit (negative amount) in the "Current Liabilities" column.

10.412 As the term implies, "estimated" misstatements are items for which the amount of the misstatement must be estimated. For example, if the auditor believes, based on prior collection history, that the client's allowance for bad debts is understated, the auditor would determine (with the client's assistance and input) the additional reserve needed, and would post this estimate to the Form as a debit (positive amount) in the "Estimated Misstatements" column and a credit (negative amount) in the "Current Liabilities" column.

10.413 "Projected" misstatements arise from projecting sampling errors to the sampling population (see the Audit Sampling Evaluation Form — Tests of Details Sampling, section 5.611). For example, if a $1,000 accounts receivable misstatement is found in a sample of 10% of the population, the projected misstatement would be $10,000 (posted as a debit to the "Current Assets" column and a credit to the "Projected Misstatements" column). It is important to distinguish between the different types of income statement misstatements to aid in assessing the overall impact the unrecorded misstatements have on the financial statements. The "Total" column in the income statement section represents the sum of the known, estimated, and projected misstatements in the income statement columns.

10.414 After all proposed journal entries have been posted to the Form and reviewed by the engagement partner, they should be discussed with the client. All entries subsequently recorded by the client should be removed from this Form and recorded on the trial balance so that only **unrecorded** entries remain on the Form. The columns for each key component should be totaled and then compared to the corresponding financial statement amounts. The total unrecorded income statement misstatements should be tax effected using the client's effective tax rate and compared to net income. The total unrecorded misstatements should be compared to the financial statement totals as a whole and by key component.

10.415 Concluding on the effect of misstatements on the financial statements is a matter of judgment and generally involves considering the nature of the misstatements (known, estimated or projected), overall materiality, and their impact on the financial statements taken as a whole. In instances when net income approaches zero, other factors may be considered, such as the effect of the misstatements on the stockholders' equity, whether recording the adjustment to correct the misstatements would cause net income to become a loss, and historical earnings trends of the entity.

10.416 Adjustments would be proposed after considering the aggregate effects of all of the misstatements. If there are no known, projected, or estimated misstatements, this fact should be documented on the Summary of Possible Journal Entries Form.

10.500 CLIENT REPRESENTATIONS

10.501 The purpose of a client representation letter is to document oral and written representations made by the client to firm personnel during the course of the engagement, including representations made through the financial statements. While representations are not a substitute for applying necessary auditing procedures, they are considered an important part of the evidential matter an auditor must obtain. Further, the auditor should discuss the letter with the client since the client needs to understand the significance of the letter rather than making the letter a mere formality. Management's refusal to sign the representation letter constitutes a scope limitation.

10.502 SAS No. 19, *Client Representations* (AU 333), establishes a requirement that the independent auditor obtain written representations from management on all audit engagements. It does not specify the form and content of a client representation letter; however, AU 333.04 provides a detailed listing of representations the auditor should consider obtaining. Those that apply to most auto dealership engagements include:

- Management's acknowledgement of its responsibility for the fair presentation of the financial statements.
- Availability of all financial records and related data.
- Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.
- Absence of errors in the financial statements and unrecorded transactions.
- Information about related-party transactions and related amounts receivable or payable.
- Noncompliance with aspects of contractual agreements that may affect the financial statements.
- Information about subsequent events.
- Irregularities involving management or employees.
- Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
- Plans or intentions that may affect the carrying value or classification of assets or liabilities.
- Disclosure of compensating balance or other arrangements involving restrictions on cash balances, and disclosure of line-of-credit or similar arrangements.
- Reduction of excess or obsolete inventories to net realizable value.
- Satisfactory title to assets, liens on assets, and assets pledged as collateral.

- Agreements to repurchase assets previously sold.
- Losses from purchase commitments for inventory quantities in excess of requirements or at prices in excess of market.
- Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
- Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by SFAS No. 5.
- Unasserted claims or assessments that the client's lawyer has advised are probable of assertion and must be disclosed in accordance with SFAS No. 5.
- Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

10.503 Management and the auditor may reach an understanding to limit management's representations to matters that are considered either individually or collectively material to the financial statements. Such limitations would not apply to those representations that are not directly related to amounts included in the financial statements or that relate to irregularities involving management or employees with significant roles in the internal control structure.

10.504 In addition to the specific representations discussed above, the auditor may determine, based on engagement circumstances, that other matters should be included in management's written representations. Examples of such additional representations applicable to a dealership include:

- Adequacy of the provision for repossession losses and finance and insurance reserve chargebacks.
- A statement that the dealership is not out of trust as of the balance-sheet date.
- Confirmation of the owner's intention to contribute necessary funds to the dealership in the event of working capital deficiencies.
- Status of any environmental matters that may affect the dealership's financial statements (e.g., liabilities resulting from compliance with environmental laws and regulations or the actual or potential cleanup of property used for underground fuel storage tanks).
- Certain significant risks and uncertainties.

10.505 The client representation letter should be dated as of the date of the auditor's report and signed by, at a minimum, the chief executive officer and the chief financial officer of the dealership. A sample client representation letter is shown in section 10.905. This letter should be tailored to fit the circumstances of each engagement.

10.600 REQUIRED COMMUNICATIONS

Overview

10.601 Several SASs require that certain matters be communicated to clients. The following is a summary of these requirements for audits conducted in accordance with generally accepted auditing standards (GAAS):

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU 316), and SAS No. 54, *Illegal Acts by Clients* (AU 317), require auditors to report any irregularities and illegal acts (unless they are clearly inconsequential) the auditor becomes aware of during the course of the audit.
- SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU 325), requires that auditors communicate significant deficiencies in the design or operation of the entity's control structure (referred to as "reportable conditions") that could adversely affect the dealership's ability to record, process, summarize, and report financial data consistent with management's financial statement assertions regarding existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure.
- SAS No. 61, *Communication with Audit Committees* (AU 380), specifies certain audit-related matters that auditors should communicate to their clients.

10.602 Although the title of SAS No. 61 seems to indicate that it only applies to entities that have audit committees, it in fact applies to any entity that has formally designated oversight of the financial reporting process to a group equivalent to an audit committee, such as a finance or budget committee. As a result, if the dealership has an audit committee or a formally designated oversight group, the auditor would be required to communicate the matters discussed in SAS No. 61 to the audit committee (see section 10.618). If the dealership does **not** have an audit committee or formally designated group that oversees the financial reporting process, auditors may choose to communicate the matters discussed in SAS No. 61 if they believe the owner, management or members of the board would benefit from such communication.

10.603 Persons to Whom Communications Should be Directed. Communications under the four SASs listed above should be directed to the audit committee, or if there is no audit committee, to the individuals with equivalent authority, such as the board of directors. As mentioned above, the SAS No. 61 communication is not required if there is no formally designated group responsible for overseeing the financial reporting process; however, communications of internal control structure related matters and irregularities and illegal acts is required even if the dealership does not have an audit committee.

10.604 Must the Communications be in Writing? The communications required under SAS Nos. 53, 54, 60, and 61 may be either oral or written. Oral communications should be documented in the working papers. Written communications should indicate that they are solely for the use of the board of directors, audit committee, or, if appropriate, management.

10.605 The required communications are generally made at the end of the audit. However, if the matter is significant or requires immediate corrective action, the auditor may want to communicate the matter before the end of the audit. The Engagement Performance Review Checklist in section 10.908 contains a step to remind engagement personnel that these communications must be made.

Errors, Irregularities, and Illegal Acts

10.606 Audit planning involves assessing the risk that errors, irregularities, and illegal acts having a direct effect on financial statement amounts may occur and cause the financial statements to contain a material misstatement. The auditor's responsibility to assess this risk and design appropriate auditing procedures to reduce this risk to an acceptable level is discussed in sections 4.325–4.342 of Chapter 4.

10.607 Communication of Irregularities and Illegal Acts. SAS Nos. 53 and 54 require the auditor to ensure that the dealership's audit committee, or others of equivalent authority, is adequately informed of any irregularities and illegal acts having direct and indirect effects on the financial statements, unless they are clearly inconsequential. If senior management participates in the illegal act, the auditor must directly inform the audit committee. With respect to illegal acts, the communication should describe the act, the circumstances of its occurrence, and its effect on the financial statements.

10.608 Communication of Errors. SAS No. 53 does not specifically require that errors be communicated; however, if the dealership is subject to SAS No. 61 (that is, it has an audit committee or other formally designated group responsible for oversight of the financial reporting process), then the auditor must communicate information about errors in the financial statements. See section 10.618 for a discussion of the communication requirements under SAS No. 61.

10.609 The Engagement Performance Review Checklist in section 10.908 contains a step to remind the auditor of the requirements to communicate irregularities and illegal acts.

Internal Control Structure Related Matters

10.610 As mentioned in section 10.601, as a part of an audit in accordance with GAAS, an auditor must communicate to the client reportable conditions noted in an audit. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU 325.02), explains that reportable conditions:

> . . . are matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such deficiencies may involve aspects of the internal control structure elements of (a) the control environment, (b) the accounting system, or (c) control procedures.

10.611 SAS No. 60 establishes two categories of reportable conditions: deficiencies in the design of the internal control structure, and deficiencies in the operation of the internal control structure. Design deficiencies relate to inadequate or absent control structure policies and procedures that could adversely affect the entity's ability to record and report financial information. For example, a design deficiency could exist in a dealership if it does not have policies and procedures that require the reconciliation of the list of new cars on floor plan to the floor plan liability control account in the general ledger. A deficiency in the operation of the control structure occurs when the entity has designed appropriate control policies and procedures, but they are not being followed or they are ineffective. Using the example above, an operational deficiency would occur if the dealership's policies and procedures require the reconciliation of the list of new cars on floor plan to the control account, but the reconciliation is not performed.

10.612 Material Weaknesses. Some reportable conditions may be of such a magnitude that a material error or irregularity could occur and not be detected timely by employees in performing their normal assigned functions. These reportable conditions are considered material weaknesses. Many auditors separately identify material weaknesses from other reportable conditions in their written communications, either because the client asks them to do so or because they want to emphasize the conditions; however SAS No. 60 does not require that an auditor separately identify material weaknesses in the report on reportable conditions.

10.613 Operations and Management-Related Matters. SAS No. 60 also recognizes that an auditor may identify other matters during the course of the audit that would benefit management or the audit committee that are not reportable conditions. For example, the auditor may want to communicate to management suggestions for improving operational and administrative efficiencies. In communications that contain both reportable conditions (see section 10.610) and other matters, it may be appropriate to indicate which comments are in each category.

10.614 Reporting Requirements. The report on reportable conditions should:

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure.
- Include the definition of reportable conditions.
- Include the restriction on distribution that states that the communication is intended solely for the information and use of the audit committee, management, and others within the dealership.

To avoid misunderstandings, a written communication indicating that no reportable conditions were noted during the audit should *not* be issued.

10.615 The following is a sample report on reportable conditions based on the guidance in SAS No. 60 (AU 325.12):

> In planning and performing our audit of the financial statements of the ABC Auto Dealership for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the dealership's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
>
> (Describe the reportable conditions noted.)
>
> This report is intended solely for the information and use of the audit committee (board of directors or owners), management, and others within the organization (or specified regulatory agency or other specified third party).

A sample report on reportable conditions is shown at section 10.906.

10.616 When reportable conditions have been identified but none is deemed a material weakness, the auditor may use the following format for a written communication:

> (Include the first paragraph of the report illustrated in section 10.615.)
>
> (Describe the reportable conditions noted.)
>
> A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
>
> Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.
>
> (Include the final paragraph from section 10.615 above.)

A sample report on reportable conditions that also identifies material weaknesses is shown at section 10.907.

10.617 The Internal Control Structure Reportable Conditions Form included in section 6.400, Chapter 6, is provided to accumulate the reportable conditions identified during the course of an audit. The Engagement Performance Review Checklist in section 10.908 contains a reminder to perform this communication before the engagement is completed.

Other Matters

10.618 SAS No. 61, *Communication With Audit Committees* (AU 380), requires the auditor to communicate certain matters about the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process. As mentioned in section 10.602, this communication is required only for dealerships that have an audit committee or formally designated group responsible for the oversight of the financial reporting process; however, auditors of dealerships that do not have such groups may find such communications beneficial. SAS No. 61 (AU 380.06–.14) requires communication of the following matters:

- The level of responsibility assumed by the auditor in an audit performed in accordance with GAAS concerning matters of interest to an audit committee, such as the internal control structure and whether the financial statements are free of material misstatement.
- The initial selection of and changes in significant accounting policies or their application, including methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is no authoritative guidance or consensus.
- The process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions about the reasonableness of those estimates.

- Adjustments arising from the audit that could, in the auditor's judgment, either individually or in the aggregate, have a significant effect on the dealership's financial reporting process.
- The auditor's responsibility for other information in documents containing audited financial statements, any procedures performed, and the results.
- Disagreements with management, whether or not satisfactorily resolved, if they relate to matters that individually or in the aggregate could be significant to the dealership's financial statements or the auditor's report. These disagreements may relate to:
  - — the application of accounting principles to specific transactions and events,
  - — the basis for management's judgments about accounting estimates,
  - — the scope of the audit or the wording of the auditor's report, or
  - — disclosures to be included in the dealership's financial statements.
- The auditor's views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters.
- Any major issues discussed with management in connection with the initial or recurring retention of the auditor, including any discussion about the application of accounting principles and auditing standards.
- Any serious difficulties encountered in dealing with management during the audit, such as unreasonable delays by management in permitting the commencement of the audit or in providing needed information, whether the timetable set by management was unreasonable under the circumstances, the unavailability of client personnel, or the failure of client personnel to complete client-prepared schedules on a timely basis.

10.619 The Engagement Performance Review Checklist in section 10.908 contains a step to remind the auditor of this required communication.

10.700 SUPERVISION AND REVIEW AND PREPARING FINANCIAL STATEMENTS AND AUDITOR'S REPORTS

Supervision and Review

10.701 Effective supervision, one of the nine elements of a system of quality control for CPA firms outlined in Statement on Quality Control Standards (SQCS) No. 1, *System of Quality Control for a CPA Firm*, is an essential element of quality, efficient engagements. This Statement requires firms to establish policies and procedures for conducting and supervising work at all organizational levels in order to provide reasonable assurance that the work performed meets professional standards. The sample quality control policies and procedures found in QC 90.16 provide the following three basic objectives for designing a quality control system for supervision:

- Provide procedures for planning engagements.
- Provide procedures for maintaining the firm's standards of quality for the work performed.
- Provide procedures for reviewing engagement working papers and reports.

Each firm should design quality control policies and procedures for supervision and review that fit its unique organizational and operating characteristics.

10.702 The requirement to supervise engagement personnel is also found in SAS No. 22, *Planning and Supervision* (AU 311.13), which states:

> The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report.

10.703 Proper supervision should include, among others things, the following:

- Helping assistants design procedures to resolve engagement problems early.
- Making sure assistants thoroughly understand the objectives and procedures of an assignment before beginning.
- Helping assistants to prioritize, organize, and control the approach to assigned work areas.
- Periodically checking on the assistants' progress.
- Keeping assistants informed of other engagement matters affecting the assigned work area.
- Rotating work assignments and offering assistants opportunities to work in new areas.
- Motivating assistants to maximum performance levels.
- Supervising paraprofessionals and temporary help.
- Appraising staff performance.

Review of Working Papers

10.704 The firm's quality control system for supervision should address procedures for reviewing working papers, including who performs these reviews and how the reviews are documented. In most firms the in-charge performs a detailed review of the work of all assistants to determine that sufficient evidence has been gathered to accomplish the engagement objectives and that the engagement procedures and documentation are in accordance with the firm's quality control standards. Also, the in-charge initials and dates each working paper to indicate that he or she is satisfied with the work performed.

10.705 The engagement partner is responsible for reviewing work performed by the in-charge and the results of the in-charge's review of assistants' working papers. The objectives of his or her review are to determine that sufficient evidence has been gathered to accomplish engagement objectives and that the engagement procedures and documentation are in accordance with the firm's quality control standards. The engagement partner generally reviews all of the working papers, and documents this review by initialling and dating each working paper.

10.706 The engagement partner's review should determine that all firm quality control standards have been met. Depending on the complexity of the engagement, and the experience of staff, the partner may review all engagement working papers, or may choose to review only the working papers supporting material or unusual audit areas. Working paper reviews by the partner may be documented by initials on the applicable lines of the working trial balance or lead sheets, or on the individual working papers. Reviewed checklists should be signed in the space provided for the partner.

10.707 The In-charge Review. The in-charge's detailed review of each assistant's work should be performed as frequently as possible, as each audit area is completed. Immediate feedback is often difficult to give under the time constraints of an audit, but is essential to providing effective on-the-job training. The in-charge's review procedures should include at least the following:

- Review applicable section of last year's working papers.
- Review the applicable section of the work program.
- Compare current and prior period trial balance accounts related to the work area and note variations.
- Briefly review the contents of the working papers.
- Read the conclusions.
- Review the working papers in detail for:
  - Mathematical accuracy.
  - Accomplishment of the purposes of the documentation, i.e., engagement objectives.
  - Proper performance of procedures.
  - Reasonableness of judgments.
  - Identification and follow-up of exceptions.
  - Resolution of problems and questions.
  - Projection of sample results to the population
- Determine that all work program procedures have been completed correctly.

10.708 The Partner Review. The engagement partner or his or her designee should review the work of engagement personnel as frequently as practical. Acceptable reasons for reviewing the engagement only after its final completion are rare.

10.709 The extent of the engagement partner's review may vary with the complexity and size of the engagement and the experience of engagement personnel. The partner's review should be conducted in the field whenever possible. Field reviews allow problem resolution while staff is working on the engagement, prevent typical office interruptions, enable the partner or the designee to schedule review time, and allow the partner or the designee to be seen by client personnel. Except for periodic discussions with engagement personnel, the partner's review will normally occur during the final stages of the engagement.

10.710 Completion of the Engagement Performance Review Checklist included in section 10.908 documents that the in-charge and engagement partner are satisfied that engagement personnel have been properly supervised and the work performed has been properly reviewed.

10.711 The Technical Review. As part of their quality control system for the supervision element, many firms require preissuance, technical reviews of reports and related financial statements, and often the engagement working papers, by persons not involved with the engagement. Such reviews are performed to give the firm assurance that the auditor's report, related financial statements, and the engagement working papers comply with professional standards and the firm's quality control system.

10.712 As with all quality control policies and procedures, each firm should develop policies and procedures for technical reviews that are appropriate for its practice. Many firms require these technical reviews only for certain types of engagements and special reporting situations. The authors recommend that firms carefully identify the situations in which an independent technical review is required and identify the firm personnel who have the qualifications and authority to perform such reviews.

10.713 Included in section 10.909 is a Technical Review Checklist that can be used to document technical reviews of reports, financial statements and, if necessary, the engagement working papers.

Preparing Financial Statements and Auditor's Reports

10.714 Chapter 11 contains guidance for the in-charge when drafting financial statements, notes and reports. It also contains a disclosure and reporting checklist that should be completed on all auto dealership engagements. Completion of the Engagement Performance Review Checklist in section 10.908 documents the engagement partner's approval that the financial statements and auditor's reports conform with authoritative and professional standards.

10.800 CONSULTATION ON ENGAGEMENTS, PERFORMANCE APPRAISALS, AND FINAL TIME SUMMARIZATION

Consultation on Engagements

10.801 An important part of ensuring that firms provide high-quality engagements is encouraging staff to seek assistance when needed from the appropriate individuals. They should also be advised of the individuals within or outside the firm designated as specialists in auto dealerships and other relevant areas.

10.802 SQCS No. 1 (QC 10.07) states:

> Policies and procedures for consultation should be established to provide the firm with reasonable assurance that personnel will seek assistance, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation will depend on a number of factors, including the size of the firm and the level of knowledge, competence, and judgment possessed by the persons performing the work.

10.803 All firms that are members of the AICPA Division for Firms are obligated to follow the quality control standards. However, because all AICPA members could be called upon to justify departures from these standards, every firm should establish and maintain a quality control system appropriate for its particular operational and organizational structure.

10.804 The following are three basic objectives (found in QC 90.14) for consultation that a firm should consider in developing its policies and procedures:

1. Identify areas and specialized situations where consultation is required, and encourage personnel to consult with or use authoritative sources on other complex or unusual matters.

2. Designate individuals as specialists to serve as authoritative sources, and define their authority in consultative situations. Provide procedures for resolving differences of opinion between engagement personnel and specialists.

3. Specify the extent of documentation to be provided for the results of consultation in those areas and specialized situations where consultation is required. Specify documentation, as appropriate, for other consultations.

10.805 Each firm should carefully design quality control policies and procedures over consultation that fit its unique operating and organizational characteristics. These policies and procedures should be communicated to all professional staff, preferably in a written quality control document, so that they are aware of the situations that require consultation and of the individuals from whom they should seek advice or assistance.

10.806 Examples of situations that may require consultation include:

- Going-concern problems.
- Identification of errors, irregularities, and illegal acts.
- Information that raises doubt about management's integrity.
- Unresolved disagreements among engagement personnel.
- The dealership has been designated by the Environmental Protection Agency as a potentially responsible party.

10.807 All consultations should be documented in a memorandum to the working papers that includes a description of the issue, relevant authoritative literature, and the resolution. The memo should be signed by the individual who prepared the memo, the consultant or specialist, and the engagement partner.

Performance Appraisals

10.808 Performance appraisals should be completed by the in-charge for all staff working on an engagement. Similarly, the engagement partner should perform an appraisal for the in-charge. To achieve maximum benefits from these feedback mechanisms, appraisal forms should be prepared and reviewed with the staff immediately after the engagement's completion.

Final Time Summarization

10.809 The in-charge is responsible for the final time summarization, its reconciliation to client time charges in the firm's billing records, and its final comparison to budget. Reasons for budget overruns should be documented. Suggestions for next year's possible time savings should also be included. These documents should be discussed with the engagement partner prior to preparing the final client billing. Finally, a tentative budget should be prepared for next year's engagement. Chapter 4, "Pre-Engagement Considerations and Audit Planning," includes budget and time control forms to collect the engagement staff's time and suggestions for modifying procedures on the next year's engagement.

10.900 DOCUMENTATION ASSISTANCE

10.901 INQUIRY LETTER TO LEGAL COUNSEL

[Client's Letterhead]

[Date]

____
____
____

In connection with an audit of our financial statements at ______ [balance-sheet date] and for the ______ [period] then ended, management of the Dealership has prepared, and furnished to our auditors ____________________________ [name and address of auditors], a description and evaluation of certain contingencies, including those set forth below, involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Dealership in the form of legal consultation or representation. These contingencies are regarded by management of the Dealership as material for this purpose [management may indicate a materiality limit if an understanding has been reached with the auditor]. Your response should include matters that existed at _______ [balance-sheet date] and during the period from that date to the date of your response.

Pending or Threatened Litigation (excluding unasserted claims and assessments)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the organization, such as guarantees of indebtedness of others.]

Very truly yours,

____

[Client's Authorized Signature]

Notes to User:

(1) Auditors should carefully consider the provisions of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU 337), in drafting this letter.

(2) Sending of this letter should be timed so that the lawyer's response is dated within two weeks of the auditor's report date. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

(3) If a client has not needed to retain legal counsel, an unqualified opinion may be expressed on the financial statements even though a letter from legal counsel has not been obtained. In these circumstances, a written representation should be obtained from the dealership that legal counsel has not been retained for matters concerning its operations that involve current or prospective litigation (see AICPA *Technical Practice Aids*, section 8340.10).

10.902 INQUIRY LETTER TO LEGAL COUNSEL IF MANAGEMENT HAS NOT PROVIDED DETAILS ABOUT PENDING OR THREATENED LITIGATION

[Client's Letterhead]

[Date]

____
____
____

In connection with an audit of our financial statements as of ________ [balance-sheet date], and for the ______ [period] then ended, please furnish our auditors ___________________________ [name and address of auditors] with the information requested below for which you have been engaged and to which you have devoted substantive attention on behalf of the Dealership in the form of legal consultation or representation.

Pending or threatened litigation, claims and assessments (excluding unasserted claims and assessments)

Please furnish a list of all pending or threatened litigation, claims or assessments your firm is handling on our behalf, including the following: (1) the nature of the litigation (including the amount of monetary or other damages sought); (2) progress of the case to date; (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement); and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

Unasserted claims and assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosing such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

We have represented to __________ [name of auditors] that there are no unasserted claims, which are not specifically identified in this letter, that you have advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

(If unasserted claims exist, management's listed information should include the following: (1) the nature of the matter; (2) how management intends to respond if the claim is asserted; and

(3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.)

Please furnish our auditors any explanation you consider necessary to supplement the foregoing information, including an explanation of these matters as to which your views may differ from those stated.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the Dealership, such as guarantees of indebtedness of others.]

Very truly yours,

____

[Client's Authorized Signature]

Notes to User:

(1) Auditors should carefully consider the provisions of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU 337), in drafting this letter.

(2) Sending of this letter should be timed so that the lawyer's response is dated within two weeks of the auditor's report date. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

(3) If a client has not needed to retain legal counsel, an unqualified opinion may be expressed on the financial statements even though a letter from legal counsel has not been obtained. In these circumstances, a written representation should be obtained from the dealership that legal counsel has not been retained for matters concerning its operations that involve current or prospective litigation (see AICPA *Technical Practice Aids*, section 8340.10).

10.903

Subsequent Events Review Program — Auto Dealerships

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS: This program has been developed for use on all audit engagements. It is not a substitute for professional judgment. Each step should be initialed and dated by the engagement personnel who performed the work. References to supporting workpapers should be placed in the "W/P Ref." column. Also, "N/A" should be placed in the "W/P Ref." column for any steps that are not applicable.

Procedure	Done By	Date	W/P Ref.
A. If available, review financial statements and schedules or general ledger and source journals of the dealership for the period subsequent to the balance-sheet date to ______ (last day of field work).	______	______	______
B. Refer to latest reconciliations of major bank accounts and inquire into any unusual items.	______	______	______
C. Refer to latest aging of contracts in transit and manufacturer and customer accounts receivable and compare with aging totals at the balance-sheet date. Inquire into material or troublesome accounts.	______	______	______
D. Discuss with dealership's management and investigate the following matters for the period from balance-sheet date to ______ (last day of field work). (Names of management should be recorded in working papers.)			
1. Dealership operations and market conditions.	______	______	______
2. Revenue and profit trends in the dealership compared to budget and trends in the industry.	______	______	______
3. Increases or decreases in vehicle or other costs. Consider impact on inventory valuation at balance-sheet date.	______	______	______
4. Status of items accounted for at the balance-sheet date based on tentative data.	______	______	______

SUBSEQUENT EVENTS REVIEW PROGRAM — AUTO DEALERSHIPS (Continued)

Procedure	Done By	Date	W/P Ref.
5. Commitments or plans for major purchases of capital additions and consideration of possible losses due to price trends.	_____	_____	_____
6. Federal, state and local taxes—changes in law, agents' reports, deficiency assessments, etc.	_____	_____	_____
7. Pending lawsuits.	_____	_____	_____
8. Liabilities in dispute or being contested, such as customers' claims, creditors' invoices or claims, warranties, guarantees, state and local tax assessments.	_____	_____	_____
9. Dividends declared or paid.	_____	_____	_____
10. Losses of major customers, exceptional bad debt losses, or pledging of receivables.	_____	_____	_____
11. Changes in accounting and financial policies.	_____	_____	_____
12. New employee benefit plans.	_____	_____	_____
13. New borrowings, issues of capital stock or other financing including any new dividend restrictions or important related covenants.	_____	_____	_____
14. Potential losses on marketable securities, carrying amounts of equity investments, receivables, inventory, other assets or contracts not already considered.	_____	_____	_____
15. Potential disclosure of investee activity.	_____	_____	_____
16. Regulatory commissions or governmental body requirements or laws that could adversely affect the dealership.	_____	_____	_____
17. Purchase or sale of major property and equipment; destructions or abandonments of property, etc.	_____	_____	_____
18. Status and impact of wage negotiations in progress.	_____	_____	_____

SUBSEQUENT EVENTS REVIEW PROGRAM — AUTO DEALERSHIPS (Continued)

Procedure	Done By	Date	W/P Ref.
19. Effect of changes in management, model changes, lines of business, etc.	______	______	______
20. Related-party transactions.	______	______	______
E. Read and evaluate the lawyers' responses to the letters of inquiry. (Letters should be requested from legal counsel so that replies will cover the status of litigation, etc., to a date as close as possible to the date of the auditor's report.)	______	______	______
F. Read and excerpt the available minutes of meetings of stockholders, board of directors and any board committees. Inquire as to matters discussed at meetings for which minutes are not available and obtain a letter from management confirming the subject matters discussed and any decisions reached that are to be incorporated in the formal minutes of such meetings.	______	______	______
G. Consider adjustment of year-end financial statements or disclosure of any items resulting from the above procedures.	______	______	______
H. Consider the possible effects on financial statements and disclosures of any matters causing substantial doubt about the dealership's ability to continue as a going concern for a reasonable period of time.	______	______	______
I. Discuss contents of representation letter and obtain appropriate signatures.	______	______	______
J. Additional procedures: ____________________ ____________________ ____________________	______	______	______

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

10.904

Summary of Possible Journal Entries Forms

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This Form should be prepared on all audit engagements by the in-charge and reviewed by the engagement partner. (This Form is provided on the complementary disk in Lotus 1-2-3 — release 3.1 with wysiwyg or release 3.4 and higher. The schedule includes formulas to calculate totals and percentages.)

Indicate in the space provided the overall materiality limit (obtained from the Materiality Computation Form). Also, indicate the threshold amount for posting items to this Form; items below this amount need not be posted.

This Form should be used to record all proposed journal entries, starting with the effect of unrecorded misstatements from prior years that should be carried forward (posted either individually or as one item) and continuing with current year entries. After all misstatements are posted, they should be reviewed by the engagement partner and discussed with the client. Any misstatements subsequently recorded by the client should be removed from this Form and included on the trial balance.

At the completion of the engagement, the columns should be totaled and compared to the corresponding financial statement amounts. Misstatements that affect the income statement should be reduced by any related tax effect using the client's effective tax rate.

Concluding on the effect of misstatements on the financial statements is a matter of judgment and generally involves considering the nature of the misstatement (known, estimated, or projected), overall materiality, and their impact on the financial statements taken as a whole. In instances when net income approaches zero, other factors may be considered, such as the effect of misstatements on stockholders' equity and historical earnings trends of the company.

SUMMARY OF POSSIBLE JOURNAL ENTRIES FORM

Summary of Possible Journal Entries Form

Client:

Financial Statement Date:

Overall materiality limit: $ ____________

Amount over which misstatements should be posted to this form: $ ____________

page ____

W/P Ref	Journal Entry Debit (Credit)	BALANCE SHEET Current Assets	Noncurrent Assets	Current Liabilities	Noncurrent Liabilities	Stockholder's Equity	INCOME STATEMENT Known misstatements	Estimated misstatements	Projected misstatements	TOTAL*
	Total effect of unrecorded misstatements from prior years									
Total Unrecorded Misstatements (Page ____)										

* Total of known, estimated and projected misstatements columns.

SUMMARY OF POSSIBLE JOURNAL ENTRIES FORM
(Continued)

page ___ \

		BALANCE SHEET					INCOME STATEMENT			
W/P Ref	Journal Entry Debit (Credit)	Current Assets	Noncurrent Assets	Current Liabilities	Noncurrent Liabilities	Stockholder's Equity	Known misstatements	Estimated misstatements	Projected misstatements	TOTAL*
	Totals from previous page									
Total Unrecorded Misstatements										
Corresponding Financial Statement Amounts										
% of Total Unrecorded Misstatements to Corresponding Financial Statement Amounts										

Tax effect on total unrecorded misstatements (income statement)** ______

Tax effected unrecorded misstatements ______

Net income ______

% of tax effected unrecorded misstatements to net income ______

* Total of known, estimated and projected misstatements columns.

** Apply the client's effective tax rate, if applicable, to the total unrecorded misstatements (income statement). Subtract the tax amount from the total unrecorded misstatement amount for the tax effected amount.

Conclusion: The above misstatements do not ______ do ______ materially affect the financial statements

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

10.905 SAMPLE CLIENT REPRESENTATION LETTER

[Client Letterhead]

[Auditor's Report Date]

____
____
____

In connection with your audit of the financial statements of ____________________________ [name of dealership] as of ____________ [balance-sheet date] and for the ____________ [period] then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of _____________________________ [name of dealership] in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your audit:

1. We are responsible for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

2. We have made available to you—

   a. All financial records and related data.

   b. All minutes of meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

   c. Information relating to all statutes, laws, or regulations that have a direct effect on our financial statements.

3. There have been no—

   a. Irregularities involving management or employees who have significant roles in the internal control structure.

   b. Irregularities involving other employees that could have a material effect on the financial statements.

   c. Communications from regulators concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

4. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

5. The following have been properly recorded or disclosed in the financial statements:

a. Related-party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.

b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line of credit or similar arrangements.

d. Agreements to repurchase assets previously sold.

e. Security agreements under the Uniform Commercial Code.

f. Contractual obligations for purchases of assets.

g. Asset reversion clauses, liens, encumbrances, or subordination of assets pledged as collateral in any way.

h. Subordination of any liabilities.

i. All lease or rental obligations under long-term leases.

6. There are no—

a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*.

c. Estimates subject to material change in the near term or concentrations that make the entity vulnerable to risk of severe impact in the near term that are to be disclosed in accordance with SOP 94-6.

7. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with SFAS No. 5.

8. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

9. Provision, when material, has been made to—

a. Reduce excess or obsolete inventories to their estimated net realizable value.

b. Reduce all investments for permanent declines in value.

10. The dealership has satisfactory title to all owned assets.

11. The dealership is not out of trust as of ________ [balance-sheet date].

12. Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.

13. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

14. No events (including out of trust situations) have occurred subsequent to the balance-sheet date that would require adjustment to, or disclosure in, the financial statements.

Very truly yours,

____
[Chief Executive Officer]

____
[Chief Financial Officer]

Notes to User:

(1) The auditor should also consider obtaining representations regarding the following:

- Adequacy of the provision for repossession losses and finance and insurance reserve chargebacks, where there are significant uncertainties regarding collectibility.
- Confirmation of the owner's intention to contribute necessary funds to the dealership in the event of working capital deficiencies.
- Status of any environmental matters that may affect the dealership's financial statements (e.g., liabilities resulting from noncompliance with environmental laws and regulations or the actual or potential cleanup of property used for underground fuel storage tanks).

10.906 SAMPLE REPORT ON REPORTABLE CONDITIONS

[CPA Firm Letterhead]

[Date of Auditor's Report on the Financial Statements]

The Board of Directors
XYZ Dealership
City, State

In planning and performing our audit of the financial statements of XYZ Dealership for the year ended December 31, 199X, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the dealership's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Bank Reconciliations

Bank reconciliations have been attempted for the operating cash account, but they have not been in agreement with the general ledger, often by as much as $20,000. At December 31, 199X, the general ledger balance varied from the bank reconciliation by $12,852.

In prior years, the bank reconciliations did not reconcile exactly to the general ledger; however, the variances were not as significant as in 199X. To maintain effective internal controls over cash, it is critical that bank accounts be reconciled to the general ledger monthly with differences identified and resolved immediately. At the present time, an adjusting journal entry should be made to bring the general ledger balance into agreement with the reconciled balance.

Accounts Payable

A listing of accounts payable as of December 31, 199X could not be produced to support the general ledger amount. We were able to reconcile accounts payable to the general ledger amount by reviewing computer-generated accounts payable listings dated December 29 and 30 and January 2 and 3, 199X, along with examining unpaid invoices at the time of our fieldwork, February 25, 199Y.

As indicated in previous letters to the Board of Directors, accounts payable has been an ongoing problem due to the fact that the accounts payable listing is not reconciled to the general ledger monthly. Proper recording of accounts payable is essential to the preparation of correct financial statements. Whether computer-generated or manually prepared, a detailed accounts payable listing should be reconciled monthly to the general ledger balance. All reconciliations should be reviewed and approved by someone other than the preparer, with the reviewer being responsible for ensuring that all differences are resolved.

Warranty Receivables

Warranty receivables are not being aged. An aging of warranty receivables should be prepared and those older than 30 days should be investigated. Comments should include the reasons for rejected claims to identify problem areas.

Parts Inventory

A physical inventory count of parts inventory is not being performed. Parts bins should be periodically compared to the parts counter pad so that every year, the contents of each bin will have been compared to the pad three or four times.

The general ledger and the parts counter pad are not being reconciled periodically. This reconciliation should be performed on a quarterly basis in order to identify potential problems and allow for their timely resolution.

The depreciation/appreciation amount in the parts inventory is not being determined when periodic price updates are done. After all price updates are done, the computer run that shows this amount should be saved for use in reconciling the general ledger to the counter pad.

This report is intended solely for the information and use of the audit committee (board of directors or owners in owner-managed enterprises), management, and others within the dealership.

Very truly yours,

____

[Firm's Signature]

10.907 SAMPLE REPORT ON REPORTABLE CONDITIONS THAT ALSO IDENTIFIES A MATERIAL WEAKNESS

[CPA Firm Letterhead]

[Date of Auditor's Report on the Financial Statements]

The Board of Directors
XYZ Dealership
City, State

In planning and performing our audit of the financial statements of XYZ Dealership for the year ended December 31, 199X, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the dealership's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

New Car Inventory

New and used car inventories are not being taken periodically. A physical inventory of new and used cars should be taken at the end of every month and should be reconciled to the new and used car inventory schedules maintained in the accounting department. Any discrepancies should be resolved immediately.

Floorplan Liability

The schedule of new cars on floorplan is not compared to the new car inventory schedule. At the end of every month a schedule of new cars on floorplan but not in inventory should be completed to highlight potential out of trust situations.

At the end of every quarter, a reconciliation between the floorplan statement and the general ledger detail schedule should be completed. This reconciliation will highlight potential problems that should be addressed immediately.

Bad Debts

During 199X, management approved the write-off of accounts receivable of about $4,000. The write-off was charged to sales revenue rather than to bad debt expense.

Procedures for recording bad debt write-offs should be reviewed for adequacy. All adjusting entries should be reviewed by the Controller or a member of management other than the person preparing the journal entry.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to material weaknesses as defined above. However, we believe that the following reportable condition is a material weakness.

Blank Checks

Blank checks are maintained in an unlocked cabinet along with the check signing machine. Blank checks and the check signing machine should be locked in separate locations to prevent the embezzlement of funds.

This report is intended solely for the information and use of the audit committee (board of directors or owners in owner-managed enterprises), management, and others within the dealership.

Very truly yours,

____

[Firm's Signature]

10.908

Engagement Performance Review Checklist

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This checklist documents the in-charge and engagement partner review responsibilities, as required by the firm's quality control policies and procedures.

Part I of the checklist should be completed by the in-charge at the completion of the engagement. Part II should be completed by the engagement partner.

Part I	Yes	No	See Additional Comments
Administrative Considerations			
1. Have all required engagement programs, forms, and checklists been completed, signed, and dated?	______	______	________
2. Have all working papers been reviewed for:			
a. Initials and dates of preparation and review?	______	______	________
b. Proper format, that is, headings, tickmark explanations, indexing, and cross-referencing?	______	______	________
c. Footing and testing of schedules prepared by the client?	______	______	________
d. Posting of adjustments and cross-referencing to trial balance?	______	______	________
e. Agreeing beginning balances to prior year's working papers?	______	______	________
3. Do financial statements agree with the trial balance?	______	______	________
4. Has the Time Summary Form been completed, and significant variances between budget and actual been explained?	______	______	________

ENGAGEMENT PERFORMANCE REVIEW CHECKLIST
(Continued)

	Yes	No	See Additional Comments
5. Have the following letters been obtained and reviewed for proper dating and adequacy?			
a. Management representations (dated as of the auditor's report date).	______	______	________
b. Lawyers' letters (dated within two weeks of the auditor's report date).	______	______	________
Other Considerations			
1. Have you reviewed all work done by assistants and cleared all review points?	______	______	________
2. Does the work performed accomplish the objectives of the engagement?	______	______	________
3. Do the conclusions in the working papers support the type of report issued?	______	______	________
4. Has the engagement been completed in accordance with firm policy and authoritative standards?	______	______	________
5. Have all problems been adequately resolved?	______	______	________
6. If a situation has been encountered that impairs the firm's independence, has a) a disclaimer of opinion been issued for public companies or b) a step-down to a compilation with lack of independence been noted for nonpublic companies?	______	______	________
7. Were any transactions or events encountered that, according to the firm's policy, require consultation?	______	______	________
• If yes, was consultation obtained and properly documented?	______	______	________
• If applicable, were the resolutions of differences of opinion among firm personnel documented?	______	______	________

ENGAGEMENT PERFORMANCE REVIEW CHECKLIST
(Continued)

	Yes	No	See Additional Comments
8. Have overall review analytical procedures been performed? (If necessary, attach supporting working papers.)	______	______	______
9. Has client approval of all adjustments made or deemed immaterial been obtained?	______	______	______
10. Has the Subsequent Events Review Program been completed?	______	______	______
11. Have all communications been made as required by SAS Nos. 53, 54, and 60 for:			
a. Internal control structure related matters?	______	______	______
b. Irregularities?	______	______	______
c. Illegal acts?	______	______	______
12. If the dealership has an audit committee or other formally designated group responsible for oversight of the financial reporting process, have the other matters required by SAS No. 61 been communicated?	______	______	______

13. Additional comments:

Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

ENGAGEMENT PERFORMANCE REVIEW CHECKLIST
(Continued)

Part II (To be completed by engagement partner) — Initials

1. I have reviewed the engagement working papers, work programs, checklists, etc. to the extent required by firm policy. ______

2. I have reviewed the financial statements for appropriate form and conformity with professional standards. ______

3. I have reviewed the independent auditor's report for conformity with professional standards, and have determined that the conclusions reached in the working papers support our report. ______

4. I authorize issuance of the financial statements and the report(s). ______

Prepared by: ______________________ Date: ______________________
(Engagement Partner)

10.909

Technical Review Checklist

Client: ______________________________

Financial Statement Date: ______________________________

Technical Reviewer: ______________________ Date: ______________________

INSTRUCTIONS:

This checklist should be completed by the technical reviewer of those engagements in which a technical review is required by the firm's quality control policies and procedures.

	Initials
1. Review the financial statements for appropriate form and content. Consider the appropriateness of:	
a. Titles.	______
b. Captions.	______
c. Classifications within captions.	______
d. Descriptions.	______
e. Reference to auditor's report and financial statement notes.	______
2. Compare the Financial Statement and Notes Checklist to the notes to the financial statements. Consider whether the notes are complete and worded appropriately.	______
3. Review the financial statements for any obvious departures from GAAP or OCBOA.	______
4. Read the auditor's (accountant's) report for appropriateness and conformity with professional standards.	______

TECHNICAL REVIEW CHECKLIST
(Continued)

Initials

5. If applicable, review the engagement checklists:

   a. To determine that they support the conclusions reached in the engagement. ________

   b. For potential problems. ________

6. Describe any problems noted and the way they were resolved. ________

   ____

   ____

   ____

10.910 Worksheet for Overall Review Analytical Procedures

	Review of Trends and Industry Data					
					Industry Range**	
	Previous years		Current	Industry	Small	Large
	19__	19__	19__	Average*	Dealers	Dealers
Common-size Balance Sheet						
Cash				5%	5%	6%
Accounts Receivable				9%	8%	11%
Inventory				67%	72%	53%
Other current assets				4%	3%	4%
Total current assets				85%	88%	74%
Property and equipment				10%	8%	16%
Other noncurrent assets				5%	4%	10%
Total assets				100%	100%	100%
Accounts payable				6%	6%	6%
Current loans				57%	55%	55%
Other current liabilities				6%	6%	6%
Total current liabilities				69%	67%	67%
Long-term debt				8%	8%	10%
Other noncurrent liabilities				2%	2%	1%
Equity				21%	23%	22%
Total liabilities and equity				100%	100%	100%
Common-size Income Statement						
Sales				100%	100%	100%
Gross profit				13%	13%	13%

Operating expenses				12%	12%	12%
Pre-tax income				1%	1%	1%
Ratios						
Current ratio				1.4	1.5	1.3
Quick ratio				0.3	0.3	0.4
Sales/ Accounts receivable				65	78	52
Days' sales in A/R				6	5	7
Cost of sales/ Inventory				6	5	7
Days' sales in inventory				62	68	54
Cost of sales/ Accounts payable				128	128	99
Days' purchases in A/P				3	3	4
Sales/ Working capital				34	23	54
Earn. bef. int and tax/ Interest				2.7	2.1	2.0
Fixed assets/ Net worth				0.4	0.3	0.7
Debt/ Net worth				5	4	5
Pre-tax income/ Net worth				0.24	0.19	0.24
Pre-tax income/ Assets				0.05	0.04	0.05
Sales/ Fixed assets				70	89	38
Sales/ Assets				5	5	4
Officers' comp./ Sales				0.008	0.006	0.004

* Industry data is based on published data from Robert Morris Associates, Annual Financial Statement Studies—1994; Duns Analytical Services Industry Norms and Key Business Ratios, 1993-1994; NADA, Industry Analysis and Outlook; and other observations.

** The ranges indicate how large and small auto dealerships vary from the industry average. As used here, small dealerships have less than $2 million in assets, large ones over $10 million.

Note: Industry data represent a benchmark only. Individual dealerships might vary based on factors such as product mix (for example, dealers of domestic cars tend to have less inventory than import dealers for the same level of sales; gross margins on used cars are often much higher than for new cars) and location (for example, a Mercedes dealership in Los Angeles might look different than one in Omaha).

Illustrative Audit Reports
& Financial Statements

CHAPTER 11

ILLUSTRATIVE AUDITOR'S REPORTS AND FINANCIAL STATEMENTS

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CHAPTER 11

ILLUSTRATIVE AUDITOR'S REPORTS AND FINANCIAL STATEMENTS

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CHAPTER 11

ILLUSTRATIVE AUDITOR'S REPORTS AND FINANCIAL STATEMENTS

11.000 INTRODUCTION

11.001 The contents of this chapter include those matters that the auditor needs to consider during the reporting on, and the preparation of, the financial statements. Included in this chapter are:

- Discussion of various reporting situations and recommendations on formatting auditor's reports (section 11.100)
- Examples of auditor's reports (section 11.200)
- Sample financial statements (section 11.300)
- Financial statement disclosure checklist, including a checklist for the auditor's report (section 11.400)
- Procedures for drafting and approving issuance of reports and financial statements (section 11.002)
- Financial Statement Control Form (section 11.500)

Drafting and Approving Issuance of Reports and Financial Statements

11.002 Firms should establish policies and procedures that define responsibility regarding the preparation and review of the auditor's report, financial statements, and notes to the financial statements. Firms should also identify situations in which the auditor's report, financial statements, and engagement working papers should be reviewed by someone not associated with the engagement. This review is discussed in Chapter 10, sections 10.711–10.713, and this review is documented on the Technical Review Checklist in section 10.909.

11.003 The Financial Statement Control Form, located in section 11.500, will help the auditor document his or her compliance with the firm's policies regarding the review process. It should accompany the report and financial statements through the drafting and review processes, beginning with the initial draft, and should be signed by all individuals performing the required procedures. It also documents the engagement partner's final approval to release the report to the client.

Financial Statements Included in this Manual

11.004 Sample financial statements have been provided in section 11.300. These samples are models that have been derived to assist you in preparing financial statements for your clients.

11.100 REPORTING ON AUDITED FINANCIAL STATEMENTS

Association With Financial Statements

11.101 Auditors are associated with financial statements when:

- They consent to the use of their name in documents containing financial statements.
- They submit financial statements they prepared or assisted in preparing to clients or others, even though the firm's name is not included with the statements.

11.102 It is important to note that this definition applies to situations in which the dealership is a public company or the auditor has been engaged to *audit* the financial statements. It does not apply to compilation and review engagements.

Report Preparation

11.103 Firms should develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies:

- **Letterhead.** The report should be presented on firm letterhead.
- **Title.** The report must include the word "independent."
- **Addressee.** The report should be addressed to the board of directors, owners, stockholders, partners, general partner, proprietor or to the company whose financial statements are being audited as follows:

  The Board of Directors
  XYZ Auto Dealership, Inc.
  City, State

  The Stockholders and Board of Directors
  XYZ Auto Dealership, Inc.
  City, State

- **Salutation.** A salutation should not be included on the report.
- **Report Signing.** The firm name should be manually signed by the engagement partner after completing the Financial Statement Control Form in section 11.500. The words "Certified Public Accountants" should be excluded from the signature if they are a normal part of the firm's letterhead.
- **Report Dating.** Audit reports should be dated as of the last day of field work.

  The date should be presented at the bottom of the page along with the city and state, if not included in firm letterhead, as follows:

  City, State
  April 5, 19X2

If significant subsequent events are discovered before the report is issued, but after the completion of field work, the report should be dual-dated for the subsequent event. Subsequent events affecting previously issued reports that are being reissued will also cause the report to be dual-dated. The following illustrates dual-dating:

> City, State
> February 26, 19X2, except for Note X as to which the date is
> April 5, 19X2

- **Level of Service.** The level of service performed and the nature of the report are outlined in the engagement letter. The letter should be revised for any significant changes from the original understanding with the client, i.e., in the event of a step-up or step-down in the level of service.

  A step-up in level of service may occur after a revised understanding with the client. A step-down in level of service should occur only after carefully evaluating the reasons for change because the reasons for the change may also affect the report on lower levels of service. Limitations on the scope of an audit, for example, may preclude issuing a review or compilation report.

  If more than one level of service is performed for financial statements of the same period, e.g., compilation and audit, the financial statements should be accompanied only by the report on the highest level of service performed.

Reports on Audited Financial Statements

11.104 Generally accepted auditing standards (GAAS) establish reporting responsibilities. The four standards of reporting stated in AU 150.02 are:

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The report shall identify those circumstances in which GAAP has not been consistently applied in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements taken as a whole, or a statement that an opinion cannot be expressed. When an opinion cannot be expressed, the reasons should be stated. In all cases, the report should contain a clear-cut indication of the degree of responsibility, if any, the auditor is taking.

Standard Report

11.105 The standard auditor's report prescribed by Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AU 508), should be used when the auditor has formed an opinion, based on the application of GAAS, that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in accordance with GAAP. It should address all financial statements presented. A standard auditor's report for the presentation of comparative financial statements is illustrated in section 11.201.

Modifications of the Standard Auditor's Report

11.106 SAS No. 58 describes situations that may require auditors to modify the standard report, and also provides illustrations of the appropriate modifying language. These modifications, which are discussed in greater depth in the following sections, are:

Explanatory Language. A wide variety of situations may arise that require a modification of the standard auditor's report, without affecting the expression of an unqualified opinion. Some of the more common of such situations are uncertainties, going-concern problems, part of the financial statements have been audited by another auditor, or a significant change in accounting principles. The explanatory paragraph for situations that do not affect the auditor's opinion should be placed after the opinion paragraph.

Qualified Opinion. Qualified opinions result from two general categories of situations: scope limitations and departures from GAAP. A scope limitation arises when the auditor has been unable to perform all of the auditing procedures he or she believes are necessary to express an unqualified opinion on the financial statements. Financial statements containing a material departure from GAAP, including inadequate disclosures in the financial statements, may lead the auditor to qualify his or her opinion. Both situations require that an explanatory paragraph, preceding the opinion paragraph, be included that describes the nature of the scope limitation or the departure from GAAP.

Disclaimer of Opinion. A disclaimer of opinion may be required when:

- The scope of the audit has been restricted so significantly that the auditor does not have a basis for forming an opinion on the financial statements. In this case, an explanatory paragraph, preceding the disclaimer paragraph, should be included in the auditor's report to explain all significant reasons for the disclaimer.
- The auditor is not independent, in which case a one-paragraph disclaimer is issued (applies to publicly held entities only). A compilation report with a lack of independence noted should be issued for nonpublic entities.

Adverse Opinion. An adverse opinion should be expressed on financial statements that do not present fairly the entity's financial position, results of operations, or cash flows in conformity with GAAP. In other words, the auditor concludes that the financial statements are *not* fairly presented in accordance with GAAP. Issuance of an adverse opinion requires inclusion of an explanatory paragraph, preceding the opinion paragraph, that explains all of the reasons for the adverse opinion and, if practicable, the effects of the subject matter of the adverse opinion on the financial statements.

Scope Limitations

11.107 Restrictions on the scope of an audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient, competent evidential matter, or an inadequacy in the client's accounting records, may require a qualified opinion or a disclaimer of opinion. Deciding whether to qualify or disclaim is a matter of judgment, and generally the primary factor in this decision is the materiality of the financial statement items affected. However, other factors should be considered, such as the pervasiveness of the effects of the omitted auditing procedures and the nature of the financial statement items affected.

Departures From GAAP

11.108 Unacceptable Principles. Significant departures from GAAP require that the auditor issue either a qualified or adverse opinion. Choosing between a qualified or adverse opinion depends on the magnitude of the departure. While the materiality of the effects of the departure is a primary consideration, the auditor should also consider the pervasiveness of the departure, such as the number of financial statement items affected, the importance of the departure to the entity's activities, and the dollar effect of the departure on individual financial statement items as well as the statements as a whole.

11.109 For both qualified and adverse opinions, an explanatory paragraph should be included, preceding the opinion paragraph, that describes all of the substantive reasons for the qualification, and the effects on the financial statements, if readily determinable. If it is not practical to determine the effects of the departure, the explanatory paragraph should contain a statement to that effect. If information about the effects of the departure are described in the notes, the explanatory paragraph can be shortened by referring to the note.

11.110 Inadequate Disclosure. Departures from GAAP include not just inappropriate application of accounting principles, but also omitted or inadequate disclosures in the financial statements. Such situations require the auditor to add an explanatory paragraph, preceding the opinion paragraph, that describes the nature of the inadequate or omitted disclosure and, if practical, the information that should have been disclosed. The significance of the omitted or inadequate disclosure will determine whether a qualified or adverse opinion is appropriate.

11.111 Report Modification. The opinion paragraph for a qualified opinion due to a departure from GAAP should include the words "except" or "exception" and a reference to the explanatory paragraph that describes that departure. Adverse opinions should include language such as "do not present fairly" and should also include a reference to the explanatory paragraph.

Errors, Irregularities, and Illegal Acts

11.112 If the financial statements are materially affected by an error, irregularity or illegal act that has not been properly accounted for and disclosed, a qualified or adverse opinion should be considered. If the auditor is precluded from applying necessary procedures or from obtaining sufficient information to conclude whether an error, irregularity or illegal act that could be material to the financial statements has occurred, a qualified or disclaimer of opinion should be issued.

11.113 If a client will not accept modification of the report under the circumstances above, the firm should consider withdrawing from the engagement and consulting with legal counsel.

Lack of Consistency

11.114 Accounting changes affecting consistency include:

- A change from one generally accepted accounting principle to another method, practice or principle that is different from the one previously used
- A change from an unacceptable to an acceptable principle (correction of an error)

- A change in financial statement classification that significantly affects financial position or results of operations (e.g., classification of an item in earnings from operations as other income or expense)
- A change in reporting entity.

11.115 Accounting changes not normally affecting consistency include:

- Initial adoption of an existing accounting principle for a new event or transaction
- Insignificant reclassification
- Correction of errors not involving a principle
- Changes in accounting estimates.

11.116 The nature of the accounting change will determine whether prior periods should be restated or a cumulative adjustment should be included in current activities. In either event, the change should be disclosed in the notes to the financial statements and in the auditor's report in a separate paragraph following the opinion paragraph. The auditor's concurrence with a change is implicit unless he or she takes exception to the change. The opinion paragraph would be standard unless the change is to an unacceptable principle or method, the change is not justified, or the change in principle is accounted for incorrectly. In such situations, either a qualified or adverse opinion should be issued.

Uncertainties

11.117 Uncertainties are significant circumstances, events, or transactions affecting the financial statements, the outcome of which cannot be reasonably estimated. Uncertainties are a particularly complex area because they can result in a qualified or adverse opinion due to a departure from GAAP or merely an explanatory paragraph that does not affect the auditor's opinion. SFAS No. 5, *Accounting for Contingencies* (CT C59) and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, are the primary authoritative pronouncements for financial statement presentation and disclosure of uncertainties.

Practice Tip

As this Manual went to press, the Auditing Standards Board had issued an Exposure Draft of a proposed Amendment to Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*, that would eliminate the required uncertainties paragraph in the auditor's report, if the uncertainties are adequately disclosed in the notes to the financial statements. Auditors should ascertain the status of this pronouncement (by calling AICPA Technical Information Hotline at (800) TO-AICPA) before adding an uncertainties explanatory paragraph to an auditor's report.

11.118 Uncertainties Not Requiring Modification of the Opinion. Paragraph 23 of SAS No. 58 (AU 508.23) states that when the auditor has concluded that an uncertainty exists, he or she should consider whether the matter warrants disclosure in the notes to the financial statements and inclusion of an explanatory paragraph in the auditor's report. This assessment is based on the likelihood that the resolution of the uncertainty will result in a material loss. If management and the auditor believe the likelihood of a material loss is "remote," no explanatory paragraph or disclosure would be required. If the likelihood of a material loss is "probable" and, in some instances "reasonably possible," the uncertainty should be disclosed in the notes to the financial statements and the auditor should include an explanatory paragraph in the report. The explanatory paragraph should describe the uncertainty and indicate that the outcome cannot presently be determined. This paragraph may be shortened by referring to information in the notes to the financial statements. Because this situation does not result in a modified opinion, no mention should be made of the uncertainty in the introductory, scope, or opinion paragraphs of the report.

11.119 Departures From GAAP. SAS No. 58, paragraph 19 (AU 508.19) describes three categories of departures from GAAP involving uncertainties:

- Inadequate disclosure
- Inappropriate accounting principles
- Unreasonable accounting estimates

11.120 As mentioned in section 11.117, SFAS No. 5 sets forth the disclosure requirements for uncertainties. A qualified or adverse opinion due to a departure from GAAP may be necessary if the auditor concludes that the uncertainty has not been appropriately disclosed in accordance with SFAS No. 5.

11.121 Also, a departure from GAAP may exist if management has made inappropriate estimates of future events in applying accounting principles (such as the use of unreasonable reserve for future finance and income chargebacks) or in making other accounting estimates.

11.122 Resolution of the Uncertainty. When the auditor has issued a report for a previous period that includes a paragraph for an uncertainty, and this uncertainty is resolved in the current period, the explanatory paragraph should be removed when issuing comparative financial statements that includes the previous period, and any effects of the uncertainty should be recorded in the period of resolution.

11.123 An example of an explanatory paragraph (following the opinion paragraph) describing an uncertainty follows:

> As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging violations of agreements not to compete. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

11.124 Going-Concern Uncertainties. If the auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern, the situation should be described in an explanatory paragraph, following the opinion paragraph. The explanatory paragraph should describe the principal events and conditions related to the going-concern, their possible effects on the financial statements, management's plans for corrective actions, and the auditor's conclusion that substantial doubt exists. SAS No. 64, *Omnibus Statement on Auditing Standards*, imposes the additional requirement that the explanatory paragraph include the terms "substantial doubt" and "going concern."

11.125 If financial statement disclosures about the uncertainty are inadequate, a departure from GAAP exists, and either a qualified or adverse opinion may be necessary. A report example of a going concern uncertainty is presented in section 11.202.

Reporting on Supplementary Information

11.126 Supplementary information includes detailed schedules of other data that are not necessary for a fair presentation of the basic financial statements. Whenever supplementary information is included in an auditor-submitted document, the auditor must indicate the degree of responsibility, if any, taken for this information. A separate report on the supplementary information or a separate paragraph in the report on the basic financial statements may be used to report on supplementary information. If a separate report is issued, it should be on the firm's letterhead and be signed. The report date should be the same as for the basic financial statements.

11.127 Reports on supplementary information should express or disclaim audit assurance. The extent and results of testing of supplementary information will determine the firm's responsibility in each circumstance. If a separate report on the supplementary information is issued, the first sentence of that report should refer to the report on the basic financial statements.

Reporting on a Single Statement

11.128 In certain circumstances, an engagement to audit a single financial statement (such as a balance sheet only) may be accepted. Generally these engagements, called "limited reporting engagements," are a result of the client needing a single financial statement to fulfill a contractual requirement, such as an entity that must provide its landlord with an audited income statement for purposes of calculating rent. Also, entities that have never been audited often request an audit of the balance sheet only for the first year, with the intention of having audits of the entire financial statements in the future. Generally such engagements are accepted as long as there is a legitimate reason for the limited engagement, and provided there are no restrictions on the access to information underlying the financial statements or on the scope of the procedures the auditor needs to perform. In such engagements, an unqualified opinion can be expressed on the financial statement the auditor was engaged to audit. If the other financial statements are presented, a disclaimer of opinion should be issued on those statements.

Relying on the Work of a Specialist

11.129 The firm may use the work of specialists to obtain support for certain representations in the financial statements. If a review of the specialist's work finds it satisfactory, and if no report modification is necessary because of the specialist's findings, there is no need to refer to the specialist's work.

11.130 If the specialist's work is not adequate to support the financial statement representations, a qualification or disclaimer of opinion because of a scope limitation may be required. Findings of the specialist that indicate the financial statements are not in accordance with GAAP may require a qualified or adverse opinion.

Lack of Independence

11.131 For public entities, whenever the auditor is not independent with respect to a client whose financial statements have been audited, a disclaimer of opinion should be issued. For nonpublic entities, the firm should issue a compilation report that includes a statement that the firm is not independent.

Reissuance of Audit Reports as Predecessors

11.132 If the auditor is asked by a former client to reissue its report on prior-period financial statements, he or she should inform the client of the procedures necessary to comply with that request. If the client agrees to perform these procedures, and pay the fee for these services, the auditor would ordinarily agree to reissue the report.

11.133 Before reissuing a report, the auditor should consider whether the previous opinion on those prior-period statements is still appropriate. Differences in the current form and presentation of the financial statements for the prior period, or the possibility of material subsequent events affecting those financial statements, could make the previous opinion inappropriate. The auditor should perform at least the following procedures:

1. Read the financial statements of the current period.
2. Compare the prior-period financial statements with the financial statements to be presented in comparative format by the successor.
3. Obtain a letter of representation from the successor auditor. The successor should represent that his or her audit has not revealed any matters that may have a material effect on the prior-period financial statements.

11.134 If the firm reissues its report without change, the previous report date should be used. If the financial statements or the report of the prior period are revised, the report should be dual-dated as to the event or matter causing the revision. There should be no reference to the report or the work of the successor auditor.

Reissuance of the Audit Report Subsequent to the Date of Original Issue

11.135 Occasionally the firm may be requested by a client to furnish additional copies of a previously issued report. Approval of the engagement partner is necessary to reissue a previously issued report. In such situations the authors recommend that the engagement partner prepare a memo stating the reasons for the reissuance and that he or she is not aware of any circumstances occurring since the original report date that would require adjustment to or disclosure in the financial statements.

11.136 Use of the original report date removes any implication that records, transactions, or events after that date have been audited or reviewed. Although the auditor has no responsibility to make further investigation or inquiry as to subsequent events, the engagement partner should consider a brief discussion with the client's chief financial or executive officer before reissuing his or her report.

Subsequent Discovery of Facts Existing at Report Date

11.137 Although the auditor has no obligation to make any continuing inquiries or perform other procedures after issuing his or her report, the auditor may become aware of information that affects the financial statements upon which he or she has previously reported. When becoming aware of such information, the auditor should determine (generally through discussions with management) the reliability of the information and whether such information existed at the date of the report.

11.138 If the information is reliable and did exist at the date of the report, if the report would have been affected if the information had been known at the report date, and if there are persons relying on the financial statements who would attach importance to the information, the auditor should take action to prevent future reliance on the report. If the engagement partner concludes that action should be taken to prevent future reliance on the report, he or she should advise the client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to the persons known to be, or likely to be, relying on the financial statements and related report. Disclosures should be made in one of the following ways:

- If the effects of subsequent facts can be promptly determined, disclosure should include reissuing revised financial statements and a revised report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report.
- If the current financial statements have not been released, appropriate disclosure of the revision of the prior-period financial statements can be included therein.
- When the effects of subsequent facts cannot be readily determined, revisions of financial statements and reports may be delayed. In this case, persons known to be, or likely to be, relying on the financial statements should be notified by the client that the financial statements and related reports should not be relied on, and that revised financial statements and report will be forthcoming.

11.139 If the client refuses to make the disclosures discussed above, the auditor should contact legal counsel. He or she should also notify all members of the board of directors of such refusal and that the firm will take the following steps to prevent future reliance on its report:

- Notify the client that the auditor's report must no longer be associated with the financial statements.
- Notify any applicable regulatory agencies that the report should no longer be relied upon.
- Notify each person known to be relying on the financial statements that the report should no longer be relied upon.

11.140 If the auditor's investigation of the subsequently discovered information is satisfactory, and he or she has determined that the information is reliable, the notifications in section 11.139 should include a description of the effects of the information on the financial statements. If the client has not cooperated and, as a result, the auditor has been unable to conduct a satisfactory investigation, the auditor does not need to indicate the details of the information. Instead, he or she should indicate that the auditor's report must no longer be relied upon nor should the auditor be associated with the financial statements.

Special Reports

11.141 Special reports are those issued in connection with:

- Financial statements that are prepared in accordance with an other comprehensive basis of accounting (OCBOA) other than GAAP (e.g., cash, modified-cash, or tax-basis).
- Specified elements, accounts, or items of a financial statement.
- Compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements.
- Financial presentations to comply with contractual agreements or regulatory provisions.
- Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's report.

11.142 SAS No. 62, *Special Reports*, requires that an auditor's report issued for financial statements presented on an other comprehensive basis of accounting differ from a report on GAAP financial statements in the following ways:

a. The financial statements described in the first and the opinion paragraphs will conform to the titles of the OCBOA financial statements. To avoid confusion OCBOA financial statements should not use unmodified GAAP titles such as "statement of financial position" and "statement of activities." Modified titles such as "statement of financial position — modified cash basis," "statement of assets and liabilities arising from cash transactions," and "statement of support and revenue collected and expenses paid" are common in practice.

b. An extra paragraph describing the basis of presentation is included immediately preceding the opinion paragraph.

c. The opinion paragraph makes reference to "presents fairly . . . *on the basis of accounting described in Note X.*" Note that a common error in practice is to make reference to "presents fairly . . . in conformity with GAAP."

11.200 SAMPLE AUDITOR'S REPORTS

11.201 Standard Auditor's Report

Independent Auditor's Report

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We have audited the accompanying balance sheets of XYZ Auto Dealership as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Auto Dealership as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

Note:

1. The standard auditor's report is discussed in SAS No. 58, AU 508.07–.09.

11.202 Going-Concern Uncertainty

Independent Auditor's Report

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We have audited the accompanying balance sheets of XYZ Auto Dealership as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Auto Dealership as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[Signature]

[Date]

Note:

1. SAS Nos. 59 and 64 (AU 341) establish guidance for auditors on evaluating whether there is substantial doubt about an entity's ability to continue as a going concern. This reporting example is based on AU 341.13.

11.203 Uncertainty Due to Litigation

Independent Auditor's Report

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We have audited the accompanying balance sheets of XYZ Auto Dealership as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Auto Dealership as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging mishandling of hazardous waste material. The Company has denied these allegations, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

[Signature]

[Date]

Notes:

1. Reporting on uncertainties is discussed in SAS No. 58, AU 508.16–.33. This reporting example is based on AU 508.32.

2. As this Manual went to press, the Auditing Standards Board had issued an Exposure Draft of a proposed Amendment to Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*, that would eliminate the required uncertainties paragraph in the auditor's report, if the uncertainties are adequately disclosed in the notes to the financial statements. Auditors should ascertain the status of this pronouncement (by calling AICPA Technical Information Hotline at (800) TO-AICPA) before adding an uncertainties explanatory paragraph to an auditor's report.

11.204 Opinion on Balance Sheet Only; Disclaimer of Opinion on Other Statements — Beginning Inventory Not Observed

Independent Auditor's Report

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We have audited the accompanying balance sheet of XYZ Auto Dealership as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We did not observe the taking of physical inventory at December 31, 19X1, stated in the financial statements at $______________, since that date was prior to the time we were initially engaged as auditors for the Company. We were unable to satisfy ourselves about inventory quantities by means of other auditing procedures. Accordingly, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the statements of income, retained earnings, and cash flows for the year ended December 31, 19X2.

In our opinion, the balance sheet referred to in the first paragraph presents fairly, in all material respects, the financial position of XYZ Auto Dealership as of December 31, 19X2, in conformity with generally accepted accounting principles.

[Signature]

[Date]

Note:

1. The decision to qualify or disclaim an opinion due to a scope limitation is based on the auditor's determination of the importance of the omitted procedures. Scope limitations are discussed in SAS No. 59 at AU 508.40–.46 and AU 508.70–.72.

11.205 Qualified Opinion — Departure From GAAP

Independent Auditor's Report

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We have audited the accompanying balance sheets of XYZ Auto Dealership as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has not provided for a reserve on repossession losses that, in our opinion, should be provided for in order to conform with generally accepted accounting principles. If these reserves were provided, liabilities would be increased by $______________ and $________________ and retained earnings would be decreased by $__________ and $__________ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be decreased by $______________ and $_______________, respectively, for the years then ended.

In our opinion, except for the effects of not recording a reserve for repossession losses as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Auto Dealership as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

Note:

1. Qualified opinions due to departures from GAAP are discussed in SAS No. 58 at AU 508.49–.54. If the effects of the departure are so pervasive that the auditor concludes the financial statements are not presented fairly in conformity with GAAP, an adverse opinion may be necessary, as discussed in SAS No. 58, AU 508.67–.69.

11.300 SAMPLE FINANCIAL STATEMENTS

11.301

SUNSET AUTO LLC
(LIMITED LIABILITY COMPANY)
BALANCE SHEET
DECEMBER 31, 19X4

ASSETS

Current Assets	
Cash and contracts in transit	$ 562,587
Accounts receivable (Net of allowance for doubtful accounts of $1,350)	462,347
Inventories	3,738,318
Due from related parties	14,304
Total Current Assets	4,777,556
Property and Equipment, net	263,028
Other Assets, net	37,628
	$5,078,212

LIABILITIES AND MEMBERS' EQUITY

Current Liabilities	
Floor plan notes payable	$3,028,136
Accounts payable — trade	333,732
Other payables and accrued liabilities	204,153
Due to related parties	63,642
Total Current Liabilities	3,629,663
Commitments and Contingencies	
Members' Equity	1,448,549
	$5,078,212

The accompanying notes are an integral part of these financial statements.

SUNSET AUTO LLC
(LIMITED LIABILITY COMPANY)
STATEMENT OF INCOME AND CHANGES IN MEMBERS' EQUITY
FOR THE PERIOD FROM INCEPTION (APRIL 6, 19X4)
TO DECEMBER 31, 19X4

Sales	$16,598,169
Cost of Sales	14,213,979
Gross Margin	2,384,190
Other Income, net	25,573
Operating Expenses	(1,991,723)
Net Income	418,040
Initial Members' Contribution	1,170,009
Distributions to Members	(139,500)
Members' Equity at End of Year	$ 1,448,549

The accompanying notes are an integral part of these financial statements.

SUNSET AUTO LLC
(LIMITED LIABILITY COMPANY)
STATEMENT OF CASH FLOWS
FOR THE PERIOD FROM INCEPTION (APRIL 6, 19X4)
TO DECEMBER 31, 19X4

Cash Flows From Operating Activities:	
Cash received from customers	$16,151,827
Cash paid to suppliers and employees	(17,632,612)
Other cash receipts	22,575
Interest received	2,998
Interest paid	(18,011)
Net Cash Used in Operating Activities	(1,473,223)
Cash Flows From Investing Activities:	
Additions to property and equipment	(103,212)
Payment of organization costs	(35,480)
Acquisition of dealership assets, net	(375,630)
Increase in deposits	(8,843)
Net Cash Used in Investing Activities	(523,165)
Cash Flows From Financing Activities:	
Net increase in floor plan notes payable	1,528,466
Contributions from members	1,170,009
Distributions to members	(139,500)
Net Cash Provided by Financing Activities	2,558,975
Net Increase in Cash and Contracts in Transit	$ 562,587

The accompanying notes are an integral part of these financial statements.

SUNSET AUTO LLC
(LIMITED LIABILITY COMPANY)
STATEMENT OF CASH FLOWS (Continued)
FOR THE PERIOD FROM INCEPTION (APRIL 6, 19X4)
TO DECEMBER 31, 19X4

Reconciliation of Net Income to Net Cash Used in Operating Activities:	
Net income	$ 418,040
Adjustments to reconcile net income to net cash used in operating activities:	
Depreciation and amortization	26,878
Used car writedowns	4,035
Provision for losses on accounts receivable	1,350
Increase in accounts receivable	(463,697)
Increase in inventories	(2,068,891)
Increase in due from related parties	(14,303)
Increase in reserve for future finance and insurance chargebacks	21,448
Increase in accounts payable and accrued liabilities	538,275
Increase in due to related parties	63,642
Net Cash Used in Operating Activities	$(1,473,223)
Supplemental Schedule of Noncash Investing and Financing Activities:	
As a result of the asset purchase agreement on May 21, 19X4, the Company acquired assets and incurred liabilities as follows:	
Vehicles, parts, accessories, property and equipment	1,875,300
Floor plan liability assumed upon acquisition	(1,499,670)
Cash Required Upon Acquisition	$ 375,630

The accompanying notes are an integral part of these financial statements.

SUNSET AUTO LLC
(LIMITED LIABILITY COMPANY)
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 19X4

Note 1 — Summary of Significant Accounting Policies

Business Operations

Sunset Auto LLC (the "Company") was formed as a New York Limited Liability Company, whose principal business is the retail sales of new Nissan automobiles obtained through an exclusive dealer agreement with the distributor. The Company operates mainly in the New York City area. In addition, the Company retails and wholesales replacement parts and used automobiles and provides vehicle servicing.

The Company was formed on April 6, 19X4 in order to enter into an asset purchase agreement. On May 21, 19X4, under the terms of the agreement, the Company acquired assets of approximately $1,890,000.

Major Supplier

The Company purchases substantially all of its new vehicles and parts inventory from Nissan at the prevailing prices charged by the automobile distributor to all franchised dealers.

Limited Liability Company/Income Taxes

The financial statements include only those assets, liabilities and results of operations which relate to the business of Sunset Auto LLC. The financial statements do not include any assets, liabilities, revenues, or expenses attributable to the members' individual activities.

The Company will file its income tax return on the accrual basis as a partnership for federal and state income tax purposes. As such, the Company will not pay income taxes, as any income or loss will be included in the tax returns of the individual members. Accordingly, no provision is made for income taxes in the financial statements.

In order to be classified as a partnership for federal income tax purposes, a limited liability company must lack at least two of the four following corporate characteristics:

1) Limited liability
2) Free transferability of interest
3) Centralized management
4) Continuity of life

As stipulated in the Operating Agreement ("Agreement"), the term of the Company is for thirty years, terminating in 20Z4, unless terminated earlier. In addition, the terms of the agreement limit the transferability of a member's interest without the consent of the other members.

As a limited liability company, each member's liability is limited to amounts reflected in their respective member accounts.

Note 1 — Summary of Significant Accounting Policies (Continued)

Accounts Receivable

An allowance for doubtful accounts is provided for accounts that are deemed to be uncollectible.

Inventories

New and demonstrator vehicles and parts and accessories are stated at cost, determined on the last-in, first-out (LIFO) basis, which is not in excess of market.

Used vehicles are stated at the lower of cost or market, on a specific unit basis.

All other inventories are generally stated at replacement cost which approximates cost on the first-in, first-out basis (FIFO).

Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the respective lives of the assets.

Other Assets

Other assets includes organizational costs which are being amortized on the straight-line basis over five years.

Recognition of Finance and Insurance Income

The Company includes income from finance and insurance commissions in sales and recognizes a reserve for future finance and insurance chargebacks based on industry estimates.

Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash deposits. The Company generally limits its exposure to credit risk from balances on deposit in financial institutions in excess of the FDIC-insured limit. At December 31, 19X4, the Company had approximately $200,000 in excess of these insured limits.

Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at December 31, 19X4, and revenues and expenses during the period then ended. The actual outcome of the estimates could differ from the estimates made in the preparation of the financial statements.

Note 1 — Summary of Significant Accounting Policies (Continued)

Loss Contingencies

The Company recognizes contingent losses that are both probable and estimable. In this context, the Company defines probability as circumstances under which events are likely to occur.

Statement of Cash Flows

For purposes of the statement of cash flows, the Company considers contracts in transit to be cash equivalents. Additionally, the net change in floor plan financing of inventory, obtained through a bank, is reflected as a financing activity.

Note 2 — Related Party Transactions

The Company shares common ownership and/or management and, in certain instances, engages in transactions with the following companies: Eclipse Advertising, Inc., Johnstone Realty, and John Doe Development Company. A summary of these transactions for the period ended December, 19X4 is as follows:

Rent expense	$ 154,397
Advertising expense	221,156

Amounts due from (to) related parties are non-interest bearing and are due within one year.

Note 3 — Accounts Receivable

Trade	$ 258,460
Due from manufacturer	175,852
Due from finance companies	28,035
	$ 462,347

Note 4 — Inventories

New vehicles and demonstrators	$2,856,449
Used vehicles	624,496
Parts and accessories	251,945
Other	5,428
	$3,738,318

Since this is the first year of operations of the Company, inventories and net income under the first-in, first-out (FIFO) method of inventory accounting do not differ from the last-in, first-out (LIFO) method of inventory accounting.

Note 5 — Property and Equipment

Leasehold improvements	$ 20,249
Machinery and shop equipment	89,754
Furniture and office equipment	160,700
Company vehicles	12,508
	283,211
Less accumulated depreciation	20,183
	$ 263,028

Depreciation expense for the period ended December 31, 19X4 was $20,183.

Note 6 — Other Assets

Organization costs	$ 35,480
Deposits	8,843
	44,323
Less accumulated amortization	6,695
	$ 37,628

Amortization of organization costs for the period ended December 31, 19X4 was $6,695.

Note 7 — Floor Plan Notes Payable

Floor plan notes payable on new and demonstrator vehicles bear interest at the bank's prime rate (approximately 8.5% at December 31, 19X4). The notes are collateralized by all of the Company's tangible and intangible personal property, including but not limited to substantially all new, used and demonstrator vehicles, parts and accessories inventory, accounts receivable, and all machinery and equipment. The notes are due within ten days of the vehicles being sold or within three days after receiving the sales proceeds, whichever is sooner. Payment is also required for vehicles on hand for more than 24 months. A portion of the interest on these notes (approximately $100,800) was refunded by Nissan Motor Corporation. The maximum credit line available is for $3,600,000.

Note 7 — Floor Plan Notes Payable (Continued)

The Company is required to maintain certain minimum levels of adjusted tangible net worth and adjusted working capital as follows:

	Adjusted Tangible Net Worth	Adjusted Working Capital
Years ending December 31,		
19X4	$ 900,000	$ 700,000
19X5	1,050,000	850,000
19X6	1,150,000	1,000,000
19X7 and thereafter	1,300,000	1,150,000

Vehicles securing floor plan notes of approximately $187,000 were sold prior to December 31, 19X4. The notes were paid in January, 19X5.

Interest expense for the year on all indebtedness (net of amounts refunded) was approximately $39,000.

Note 8 — Other Payables and Accrued Liabilities

Salaries and commissions	$ 66,333
Reserve for future finance and insurance chargebacks	21,420
Sales taxes	50,245
Payroll taxes	8,501
Insurance	15,785
Interest	20,783
Vacation	14,043
Miscellaneous	7,043
	$ 204,153

Note 9 — Commitments and Contingencies

Operating Leases

The Company leases the land and building of the dealership facility from an affiliate under an operating lease expiring in 20X4. The Company also has a lease agreement for other equipment. Minimum future rental payments under the leases are as follows:

Years ending December 31,

19X5	$ 331,104
19X6	331,104
19X7	331,104
19X8	329,400
19X9	329,400
Thereafter	1,468,574
	$3,120,686

Rent expense on all operating leases was approximately $204,000 for the initial period ended December 31, 19X4. Additionally, the Company is liable for property taxes and insurance.

Note 9 — Commitments and Contingencies (Continued)

Governmental Regulation

Substantially all of the facilities of the Company are subject to federal, state and local provisions regulating the discharge of materials into the environment. Compliance with these provisions has not had, nor does the Company expect such compliance to have, any material effect upon the capital expenditures, net income, financial condition or competitive position of the Company. Management believes that its current practices and procedures for the control and disposition of such wastes comply with applicable federal and state requirements.

Litigation

The Company is exposed to various asserted and unasserted potential claims encountered in the normal course of business. In the opinion of management, the resolution of these matters will not have a material effect on the Company's financial position or the results of operations of the Company.

Note 10 — 401(k) Profit Sharing Plan

In 19X4, the Company established a qualified 401(k) Profit Sharing Plan (the "Plan") available to full-time employees who meet the Plan's eligibility requirements. Contributions to the Plan are made by the Plan participants and the Company. Participants may elect to defer the receipt of a portion of their compensation on a pre-tax basis, subject to certain limitations, and direct the Company to contribute this deferral to the Plan on their behalf. Additionally, participants may roll over or transfer to the Plan any portion or all of the property received from another qualified employee benefit trust. The Company intends to contribute, annually to the Plan, 300 percent of the amount of the salary reduction each participant elects to defer. The maximum annual matching contribution per participant is $110.

In addition, the Company may elect to contribute to the Plan a special contribution equal to a percentage (to be determined by the Company each year) of each employee's compensation.

Company contributions to the Plan for profit sharing and matching of employee contributions were approximately $150 for 19X4.

11.302

RUBY RED AUTO DEALERSHIP, INC.
BALANCE SHEETS
DECEMBER 31, 19X2 AND 19X1

ASSETS

	19X2	19X1
Current Assets		
Cash and contracts in transit	$1,487,602	$1,166,266
Accounts receivable	1,141,101	636,616
Inventories	1,917,598	5,234,039
Prepaid expenses	11,528	10,526
Due from related parties	8,621	32,401
Total Current Assets	4,566,450	6,259,241
Due From Related Party	—	250,000
Property and Equipment, net of accumulated depreciation of $779,617 and $701,310 at 19X2 and 19X1, respectively	284,293	268,612
Other Assets	142,731	147,419
	$4,993,474	$4,090,793

LIABILITIES AND STOCKHOLDERS' EQUITY

	19X2	19X1
Current Liabilities		
Floor plan notes payable	$1,768,114	$1,863,611
Current maturities of obligations under a capital lease	8,832	—
Accounts payable — trade	1,059,418	309,656
Other payables and accrued liabilities	1,032,690	603,965
Due to related parties	57,102	282,182
Total Current Liabilities	3,926,156	3,059,414
Obligation Under Capital Lease, less current maturities	39,134	—
Commitments and Contingencies		
Stockholders' Equity		
Common Stock, $1 par value — authorized, 3,750 shares; 55 shares issued	55	55
Additional Paid-in Capital	247,120	247,120
Retained Earnings	786,634	789,829
	1,033,809	1,037,004
Less 2 shares in treasury, at cost	(5,625)	(5,625)
Total Stockholders' Equity	1,028,184	1,031,379
	$4,993,474	$4,090,793

The accompanying notes are an integral part of these financial statements.

RUBY RED AUTO DEALERSHIP, INC.

STATEMENTS OF INCOME

YEARS ENDED DECEMBER 31, 19X2 AND 19X1

	19X2	19X1
Sales	$39,141,533	$30,152,648
Cost of Sales	33,166,247	25,801,192
Gross Margin	5,975,286	4,351,456
Other Income — Net	107,623	86,720
Operating Expenses	(4,267,225)	(3,645,473)
Net Income	$ 1,815,684	$ 792,703

The accompanying notes are an integral part of these financial statements.

RUBY RED AUTO DEALERSHIP, INC.

STATEMENTS OF STOCKHOLDERS' EQUITY

YEARS ENDED DECEMBER 31, 19X2 AND 19X1

	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock at Cost	Total
Balance — January 1, 19X1	$ 55	$ 247,120	$ 508,147	$ (5,625)	$749,697
Net income	—	—	792,703	—	792,703
Dividends paid	—	—	(511,021)	—	(511,021)
Balance — December 31, 19X1	55	247,120	789,829	(5,625)	1,031,379
Net income	—	—	1,815,684	—	1,815,684
Dividends paid	—	—	(1,818,878)	—	(1,818,878)
Balance — December 31, 19X2	$ 55	$ 247,120	$ 786,635	$ (5,625)	$ 1,028,185

The accompanying notes are an integral part of these financial statements.

RUBY RED AUTO DEALERSHIP, INC.

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 19X2 AND 19X1

	19X2	19X1
Cash Flows From Operating Activities:		
Cash received from customers	$ 38,378,378	$ 30,107,863
Cash paid to suppliers and employees	(36,071,796)	(29,072,519)
Cash received from litigation for loss on purchase of vehicles	83,920	20,460
Other cash receipts	24,243	30,530
Interest received	27,816	26,143
Interest paid	(166,642)	(169,533)
Net Cash Provided By Operating Activities	2,275,919	942,944
Cash Flows From Investing Activities:		
Additions to property and equipment	(49,577)	(137,293)
Repayments from (loans to) related parties	250,000	(250,000)
Increase in other assets	—	(1,000)
Net Cash Provided by (Used in) Investing Activities	200,423	(388,293)
Cash Flows From Financing Activities:		
Dividends paid	(1,818,878)	(511,021)
Repayments to stockholder	(237,500)	(287,500)
Principal payments on capital lease	(3,130)	—
Decrease in floor plan notes payable	(95,498)	(15,647)
Net Cash Used in Financing Activities	(2,155,006)	(814,168)
Net Increase (Decrease) in Cash and Contracts in Transit	321,336	(259,517)
Cash and Contracts in Transit at Beginning of Year	1,166,266	1,425,783
Cash and Contracts in Transit at End of Year	$ 1,487,602	$ 1,166,266

The accompanying notes are an integral part of these financial statements.

RUBY RED AUTO DEALERSHIP, INC.

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 19X2 AND 19X1

	19X2	19X1
Reconciliation of Net Income to Net Cash Provided by Operating Activities:		
Net income	$1,815,684	$ 792,703
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	89,182	75,126
Provision for losses on accounts receivable	—	40,800
Increase in LIFO reserve	29,890	161,775
Demonstrator vehicle writedowns	14,570	28,534
Increase (decrease) in finance and insurance reserve	69,500	(9,500)
Increase in accounts receivable	(861,416)	(36,564)
Decrease (increase) in inventories	17,251	(282,864)
Increase in prepaid expenses	(11,528)	—
Decrease (increase) in due from related parties	(8,621)	3,767
Increase in accounts payable and accrued liabilities	1,108,987	166,700
Increase in due to related parties	12,420	2,467
Net Cash Provided by Operating Activities	$2,275,919	$ 942,944

	19X2	19X1
Supplemental Schedule of Noncash Investing and Financing Activities:		
Transfer of vehicles from property and equipment to used car inventory at net book value	$ 497	$ 7,930
Capital lease obligation entered into by the Company for computer equipment	$ 51,096	$ —

The accompanying notes are an integral part of these financial statements.

RUBY RED AUTO DEALERSHIP, INC.

NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 19X2 AND 19X1

Note 1—Summary of Significant Accounting Policies

Business Operations

The Company's principal business is the retail sales of new automobiles, obtained through an exclusive dealer agreement with the distributor. The Company operates mainly in the Los Angeles, California area. In addition, the Company retails and wholesales replacement parts and used automobiles and provides vehicle servicing.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash deposits. The Company generally limits its exposure to credit risk from balances on deposit in financial institutions in excess of the FDIC-insured limit. However, cash balances in excess of this limit at December 31, 19X2 were approximately $1,148,500.

Major Supplier

The Company purchases substantially all of its new vehicles and parts from Ford Motor Company, Inc. at the prevailing prices charged by the automobile distributor to all franchised dealers.

Inventories

New and demonstrator vehicles and parts and accessories are stated at cost, determined on the last-in, first-out (LIFO) basis, which is not in excess of market.

Used vehicles are stated at the lower of cost or market, on a specific unit basis.

All other inventories are generally stated at replacement cost, which approximates cost on the first-in, first-out (FIFO) basis.

Property and Equipment

Property and equipment are stated at cost. Depreciation and amortization (including property under a capital lease) are computed using the straight-line method over the useful lives of the assets.

Other Assets

Goodwill is being amortized on the straight-line method over 40 years.

Note 1 — Summary of Significant Accounting Policies (Continued)

Revenue Recognition of Finance and Insurance Income

The Company includes income from finance and insurance commissions in sales and recognizes a reserve for future finance and insurance chargebacks based on past operating history.

Income Taxes

The Company and its stockholders have elected to be treated as a "Small Business Corporation" for income tax purposes under Subchapter "S" of the Internal Revenue Code and a similar section in the State Code. In accordance with the provisions of such election, the Company's income and losses are passed through to its stockholders; accordingly, no provision for income taxes has been made.

Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at December 31, 19X2 and 19X1 and revenues and expenses during the years then ended. The actual outcome of the estimates could differ from the estimates made in the preparation of the financial statements.

Statements of Cash Flows

For purposes of the statements of cash flows, the Company considers contracts in transit to be cash equivalents. Additionally, the net change in floor plan financing of inventories obtained through a financial institution is reflected as a financing activity.

Accounts Receivable

An allowance for doubtful accounts is provided for accounts that are deemed to be uncollectible.

Note 2—Related-Party Transactions

The Company shares common ownership and/or management with ACME Management Company and Blue Sky Computer Co. The transactions, which are summarized below, include management services and various unsecured loans and advances.

A summary of transactions with affiliate for the years ended December 31, 19X2 and 19X1 follows:

	19X2	19X1
Management fees	$ 108,000	$ 108,000
Data processing fees	11,500	16,000
Workers' compensation insurance	28,650	33,000

Note 2 — Related-Party Transactions (Continued)

At December 31, the following accounts receivable (payable) balances existed with related parties:

	19X2	19X1
Current:		
Due from affiliates	$ 8,621	$ —
Due to affiliates	$ (57,102)	$ (42,197)
Due to stockholder	—	(239,985)
	$ (57,102)	$ (282,182)
Noncurrent:		
Due from affiliate	$ —	$ 250,000

During 19X1, the Company advanced $250,000 to an affiliate. This balance was repaid during 19X2.

During 19X0, a stockholder advanced the Company $525,000 for the purpose of having those funds invested with the floor plan lender at fluctuating interest rates, adjusted monthly (8.5% at December 31, 19X1). The Company repaid $287,500 to the stockholder during 19X1, and the outstanding balance of approximately $237,500 was repaid during 19X2. The interest income generated of approximately $3,000 and $49,500 for 19X2 and 1991, respectively, was paid directly to the stockholder. In both the statements of income and cash flows, the corresponding interest income and expense have been netted.

Note 3—Accounts Receivable

	December 31,	
	19X2	19X1
Trade	$ 947,736	$ 235,085
Due from finance companies	134,875	33,926
Due from manufacturer	48,267	33,943
Other	20,036	24,781
	1,150,914	327,735
Less allowance for doubtful accounts	9,813	48,050
	$1,141,101	$ 279,685

Note 4—Inventories

	December 31, 19X2	December 31, 19X1
New vehicles and demonstrators	$1,232,693	$1,406,484
Used vehicles	417,009	350,692
Parts and accessories	253,456	201,651
Other	14,440	19,984
	$1,917,598	$1,978,811

If the first-in, first-out (FIFO) method of inventory accounting were used by the Company, inventories would have been approximately $823,000 and $793,000 higher than reported at December 31, 19X2 and 19X1, respectively. The effect would have resulted in net income under the FIFO method of approximately $1,845,700 and $954,500 for the years ended December 31, 19X2 and 19X1, respectively.

Note 5—Property and Equipment

	December 31, 19X2	December 31, 19X1
Leasehold improvements	$ 644,865	$ 625,477
Furniture and fixtures	207,774	192,135
Machinery and equipment	111,544	103,266
Property under a capital lease	51,095	—
Company vehicles	48,632	49,044
	1,063,910	969,922
Less accumulated depreciation and amortization	779,617	701,310
	$ 284,293	$ 268,612

Depreciation expense for the years ended December 31, 19X2 and 19X1 was $84,494 and $72,571, respectively, including amortization of equipment under a capital lease of $2,555 in 19X2.

Note 6—Other Assets

	December 31, 19X2	December 31, 19X1
Goodwill, $187,500 acquired in connection with the acquisition of the dealership, net of amortization	$ 128,125	$ 132,813
Security deposits	14,606	14,606
	$ 142,731	$ 147,419

Note 7—Floor Plan Notes Payable

Floor plan notes payable on new and demonstrator vehicles with fluctuating interest rates based on changes in the prime rate (7.0% and 8.5% at December 31, 19X2 and 19X1, respectively) are collateralized by substantially all new and demonstrator vehicles and the proceeds of the related sales. The notes are due when the vehicles are sold. The maximum credit available under the financing arrangement is 175 new, 12 used, and 25 demonstrator vehicles.

Interest expense on all indebtedness for the years ended December 31, 19X2 and 19X1 was approximately \$170,000 and \$213,000 respectively, including \$3,000 and \$49,500, respectively, paid to a stockholder (Note 2).

Note 8—Other Payables and Accrued Liabilities

	December 31, 19X2	December 31, 19X1
Finance and insurance income reserves	\$ 381,500	\$ 312,000
Payroll and employee bonuses	391,738	153,933
Sales and payroll taxes	97,967	28,516
Customer deposits	68,039	39,278
Interest	14,435	14,296
Other	79,011	55,942
	\$1,032,690	\$ 603,965

Note 9—Commitments and Contingencies

Insurance Coverage

The Company and certain affiliates have a combined self-insured retention limit of \$750,000 for a two-year period ending December 31, 19X3 for workers' compensation insurance, with \$1,000,000 excess coverage over the retention limit.

Operating Leases

The Company is committed under various operating leases expiring through the year 20M1. Some of the leases require the payment of the base rent by the lessee plus other incidental costs such as real estate taxes, insurance, and escalating increases based on the Consumer Price Index.

Note 9 — Commitments and Contingencies (Continued)

The following is a schedule, by years, of future minimum lease payments required under operating leases:

Years ending December 31,

19X3	$ 228,758
19X4	212,276
19X5	213,075
19X6	215,471
19X7	218,560
Thereafter	596,031
	$1,684,171

Rent expense under all operating leases was approximately $229,000 and $232,500 for the years ended December 31, 19X2 and 19X1, respectively.

Capital Lease

The Company leases its computer equipment under a capital lease agreement expiring in 19X7. The following is a schedule, by years, of future minimum lease payments relating to the capital lease:

Years ending December 31,

19X3	$ 12,350
19X4	12,350
19X5	12,350
19X6	12,350
19X7	8,234
Total minimum lease payments	57,634
Less amount representing interest	9,668
	47,966
Less current maturities	8,832
	$39,134

Governmental Regulation

Substantially all of the Company's facilities are subject to federal, state, and local regulations relating to underground fuel storage tanks and the discharge of materials into the environment. Subsequent to year end, the Company entered into a contract with an environmental maintenance company to test and clean underground water drains in order to comply with federal environmental regulations. The Company has accrued approximately $86,000 for estimated costs in connection with this testing, of which $50,000 was charged to expense in 19X1 and $36,000 in 19X2.

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CHECKERED FLAG PARTNERSHIP

BALANCE SHEETS

DECEMBER 31, 19X2 AND 19X1

	19X2	19X1
Assets		
Current Assets		
Cash and contracts in transit	$ 425,799	$ 345,659
Accounts receivable	641,375	636,616
Inventories	4,602,124	5,234,039
Prepaid expenses	13,118	10,526
Due from related parties	—	32,401
Total Current Assets	5,682,416	6,259,241
Property and Equipment — Net of accumulated depreciation of $85,711 and $31,905	257,864	212,442
Due From Related Party	—	108,114
Other Assets — Net	77,936	139,359
	$6,018,216	$6,719,156
Liabilities and Partners' Capital		
Current Liabilities		
Current maturities of long-term debt	$ 9,273	$ 7,342
Current maturities of obligations under capital leases	23,494	17,800
Floor plan notes payable	3,842,587	4,610,089
Accounts payable — trade	274,254	294,156
Other payables and accrued liabilities	442,177	484,660
Due to related parties	85,858	33,493
Total Current Liabilities	4,677,643	5,447,540
Long-Term Debt, less current maturities	13,542	9,525
Obligations Under Capital Leases, less current maturities	84,225	74,700
Commitments and Contingencies		
Partners' Capital	1,242,806	1,187,391
	$6,018,216	$6,719,156

The accompanying notes are an integral part of these financial statements.

CHECKERED FLAG PARTNERSHIP

STATEMENTS OF INCOME AND CHANGES IN PARTNERS' CAPITAL

FOR THE YEAR ENDED DECEMBER 31, 19X2 AND FOR THE PERIOD FROM INCEPTION (MARCH 1, 19X1) TO DECEMBER 31, 19X1

	19X2	19X1
Sales	$31,761,314	$21,857,706
Cost of Sales	26,580,877	18,426,101
Gross Margin	5,180,437	3,431,605
Other Income	82,640	43,673
Operating Expenses	(5,086,238)	(3,207,624)
Net Income	176,839	267,654
Partners' Capital at Beginning of Year	1,187,391	—
Contributions	10,076	919,737
Drawings	(131,500)	—
Partners' Capital at End of Year	$ 1,242,806	$ 1,187,391

The accompanying notes are an integral part of these financial statements.

CHECKERED FLAG PARTNERSHIP

STATEMENTS OF CASH FLOWS

FOR THE YEAR ENDED DECEMBER 31, 19X2 AND FOR THE PERIOD FROM INCEPTION (MARCH 1, 19X1) TO DECEMBER 31, 19X1

	19X2	19X1
Cash Flows From Operating Activities:		
Cash received from customers	$31,789,408	$21,241,529
Cash paid to suppliers and employees	(30,777,624)	(24,760,924)
Other cash receipts	75,912	43,673
Interest received	6,727	—
Interest paid	(268,728)	(128,426)
Net Cash Provided by (Used in) Operating Activities	825,695	(3,604,148)
Cash Flows From Investing Activities:		
Additions to property and equipment	(56,472)	(139,696)
Proceeds from sale of property and equipment	1,500	—
Acquisition of franchise, noncompete and consulting fees	—	(137,500)
Repayments from affiliate	108,114	—
Increase in other assets	—	(7,115)
Payment for asset purchase — net of cash required	—	(612,911)
Net Cash Provided by (Used in) Investing Activities	53,142	(897,222)
Cash Flows From Financing Activities:		
Net increase (decrease) in floor plan notes	(684,003)	3,910,424
Payments of long-term debt	(5,445)	(50,000)
Increase in long-term debt	—	66,868
Payments of capital lease obligations	(18,211)	—
Advances from affiliate	50,000	—
Payments to affiliate	(19,614)	—
Distribution to partners	(131,500)	—
Contributions from partners	10,076	919,737
Net Cash Provided by (Used in) Financing Activities	(798,697)	4,847,029
Net Increase in Cash and Contracts in Transit	80,140	345,659
Cash and Contracts in Transit at Beginning of Year	345,659	—
Cash and Contracts in Transit at End of Year	$ 425,799	$ 345,659

The accompanying notes are an integral part of these financial statements.

CHECKERED FLAG PARTNERSHIP

STATEMENTS OF CASH FLOWS

FOR THE YEAR ENDED DECEMBER 31, 19X2 AND FOR THE PERIOD FROM INCEPTION (MARCH 1, 19X1) TO DECEMBER 31, 19X1

	19X2	19X1
Reconciliation of Net Income to Net Cash Provided by (Used in) Operating Activities:		
Net income	$ 176,839	$ 267,654
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Increase in LIFO reserve	82,308	122,245
Depreciation and amortization	115,797	37,160
Provision for losses on accounts receivable	3,146	8,394
Used car writedowns	—	61,000
Increase in accounts receivable	(7,905)	(645,010)
Decrease (increase) in inventories	549,602	(4,816,525)
Increase in prepaid expenses	(2,592)	(10,526)
Decrease in due from related parties	32,401	—
Increase in finance and insurance reserve	36,000	29,000
Increase (decrease) in accounts payable and accrued liabilities	(98,385)	641,702
Increase in due to related parties	21,979	1,093
Increase (decrease) in floor plan liabilities	(83,495)	699,665
Net Cash Provided (Used) by Operating Activities	$ 825,695	$(3,604,148)
Supplemental Schedule of Noncash Investing and Financing Activities:		
Property and equipment financed through capitalized lease obligations	$ 33,429	$ 92,500
Property and equipment financed through long-term debt	$ 11,394	$ —
As a result of the asset purchase agreement, on March 1, 19X1, the Partnership acquired the following:		
Vehicles, parts and accessories and fixed assets		$ 824,595
Due from related party		108,114
Liabilities and lease obligations assumed		(319,798)
Cash required upon acquisition		$ 612,911

The accompanying notes are an integral part of these financial statements.

CHECKERED FLAG PARTNERSHIP

NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 19X2 AND 19X1

Note 1 — Summary of Significant Accounting Policies

Business Operations

Checkered Flag Partnership (the "Partnership") was formed as a general partnership, whose principal business is the retail sales of new domestic automobiles. The Partnership operates mainly in Arizona. In addition, the Partnership retails and wholesales replacement parts and used automobiles and provides vehicle servicing.

The Partnership was formed on March 1, 19X1 in order to enter into an asset purchase agreement. Under the terms of the agreement, the Partnership acquired assets of approximately $1,025,000. In addition, the Partnership, together with Pit Stop Crew, a related partnership, entered into a consulting agreement with a third party in the amount of $370,000. (Note 10).

Partnership

The Partnership files its income tax return on the accrual basis and does not pay income taxes, as any income or loss is included in the tax returns of the individual partners. Accordingly, no provision is made for income taxes in the financial statements.

Major Supplier

The Partnership purchases substantially all of its new vehicles and parts from Ford Motor Company, Inc. at the prevailing prices charged by the automobile distributor to all franchised dealers.

Inventories

New and demonstrator vehicles and parts and accessories are stated at cost, determined on the last-in, first-out (LIFO) basis, which is not in excess of market.

Used vehicles are stated at the lower of cost or market, on a specific unit basis.

All other inventories are generally stated at replacement cost, which approximates cost on the first-in, first-out (FIFO) basis.

Property and Equipment

Property and equipment are stated at cost. Depreciation and amortization (including property under capital leases) are computed using the straight-line method over the useful lives of the assets.

Note 1 — Summary of Significant Accounting Policies (Continued)

Other Assets

Other assets are amortized on the straight-line method as follows:

	Years
Covenant not to compete	3
Consulting agreement	1
Organization costs	5
Goodwill	40

Revenue Recognition of Finance and Insurance Income

The Partnership includes income from finance and insurance commissions in sales and recognizes a reserve for future finance and insurance chargebacks based on industry estimates.

Concentration of Credit Risk

The Partnership maintains all of its temporary investments in a money market fund with a stock brokerage firm, which is a high credit quality financial institution. Financial instruments that potentially subject the Partnership to concentrations of credit risk consist principally of cash in excess of the SIPC-insured limit of $500,000. The Partnership generally limits the amount of its credit exposure with the financial institution by maintaining its cash balances under the insured limit.

Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at December 31, 19X2 and 19X1, and revenues and expenses during the years then ended. The actual outcome of the estimates could differ from the estimates made in the preparation of the financial statements.

Statements of Cash Flows

For purposes of the statements of cash flows, the Partnership considers contracts in transit and highly liquid debt instruments with a maturity of three months or less to be cash equivalents. Additionally, the net change in floor plan financing of inventory, obtained through a finance company, is reflected as a financing activity for foreign models, and as an operating activity for domestic models, because the finance company is a subsidiary of the manufacturer of the domestic models.

Note 2 — Related-Party Transactions

The Partnership shares common ownership and/or management and, in certain instances, engages in transactions with ACME Management Services, Inc. and Delta Advertising Company.

Note 2 — Related Party Transactions (Continued)

A summary of these transactions with these companies follows:

	19X2	19X1
Rent expense	$ 420,000	$ 256,875
Management fee expense	30,000	21,250
Advertising expense	478,500	351,900

Amounts due from and to related parties are noninterest bearing and relate to the above transactions.

Partner's salary and bonuses were approximately $660,000 and $155,000 during 19X2 and 19X1, respectively.

Note 3 — Accounts Receivable

	December 31,	
	19X2	19X1
Trade	$ 468,433	$ 548,525
Due from manufacturers	84,432	33,823
Due from finance companies	88,510	54,268
	$ 641,375	$ 636,616

The Partnership has established a mandatory write-off policy for all receivables older than 60 days. As a result of this policy, no allowance for uncollectible accounts is deemed necessary.

Note 4 — Inventories

	December 31,	
	19X2	19X1
New vehicles and demonstrators	$3,535,319	$4,258,706
Used vehicles	580,927	530,415
Parts and accessories	482,730	440,716
Other	3,148	4,202
	$4,602,124	$5,234,039

If the first-in, first-out (FIFO) method of inventory accounting were used, inventories would have been approximately $204,500 and $122,000 higher than reported at December 31, 19X2 and 19X1, respectively. In addition, the net income under FIFO would have been approximately $259,000 and $390,000 for the year ended December 31, 19X2 and the ten months ended December 31, 19X1, respectively.

Note 5 — Property and Equipment

	December 31, 19X2	December 31, 19X1
Leasehold improvements	$ 3,989	$ —
Machinery and shop equipment	96,445	65,693
Parts equipment	19,894	19,894
Furniture and office equipment	53,856	38,994
Property under capital leases	125,929	92,500
Company vehicles	43,462	27,266
	343,575	244,347
Less accumulated depreciation and amortization, including $30,165 in 19X2 and $7,765 in 19X1, on property under capital leases	85,711	31,905
	$ 257,864	$ 212,442

Depreciation expense for 19X2 and 19X1 was $54,373 and $31,905, including amortization of equipment under the capital leases of $22,400 and $7,765, respectively.

Note 6 — Other Assets

	December 31, 19X2	December 31, 19X1
Covenant not to compete	$ 75,000	$ 75,000
Consulting agreement	37,500	37,500
Organization costs	7,115	7,115
Goodwill	25,000	25,000
	144,615	144,615
Less accumulated amortization	66,679	5,256
	$ 77,936	$ 139,359

Note 7 — Floor Plan Notes Payable

Floor plan notes are payable on new and demonstrator vehicles with interest rates at prime rate plus 1% (approximately 7% and 8.5% at December 31, 19X2 and 19X1, respectively). The notes are collateralized by all tangible and intangible personal property, including, but not limited to, substantially all new, used and demonstrator vehicles, parts and accessories inventory, accounts receivable, and certain machinery and equipment, and are partially guaranteed by the partners individually. The notes are due when the vehicles are sold. The maximum credit line is available for 433 vehicles.

Vehicles securing floor plan notes of approximately $259,000 and $367,000 were sold prior to December 31, 19X2 and 19X1, respectively. The underlying notes were paid in January, 19X3 and 19X2, respectively.

Interest expense for 19X2 and 19X1 on all indebtedness (net of amounts refunded) was approximately $254,350 and $166,450, respectively.

Note 8 — Other Payables and Accrued Liabilities

	December 31, 19X2	December 31, 19X1
Salaries and commissions	$ 131,460	$ 94,502
Finance and insurance income reserves	65,000	29,000
Property taxes	78,993	76,366
Insurance	18,691	15,029
Interest	23,599	38,001
Professional fees	40,316	21,286
Customer deposits	6,872	—
Consulting fee	50,964	138,864
Miscellaneous	26,282	71,612
	$ 442,177	$ 484,660

Note 9 — Long-Term Debt

	December 31, 19X2	December 31, 19X1
Note payable	$ 20,473	$ 14,525
Other debt	2,342	2,342
	22,815	16,867
Less current portion	9,273	7,342
	$ 13,542	$ 9,525

A note payable on equipment, with interest at 10% is payable in monthly principal and interest payments of $519. The note was originally due in July, 19X4. In October, 19X2, the note was renegotiated in conjunction with the purchase of additional equipment. The terms of the new note provide an interest rate of 8%, and monthly principal and interest payments of $693. The new note matures in September, 19X5 and is collateralized by the related equipment having a carrying value of approximately $27,500.

The aggregate maturities of long-term debt are as follows:

Years ended December 31,

19X3	$ 9,273
19X4	7,506
19X5	6,036
	$ 22,815

Note 10 — Commitments and Contingencies

Capital Leases

The Partnership leases equipment under capital lease agreements expiring in 19X7. The following is a schedule, by years, of future minimum lease payments:

Years ending December 31,

19X3	$ 30,757
19X4	30,757
19X5	30,757
19X6	30,757
19X7	3,351
Total minimum lease payments	126,379
Less amount representing interest	18,660
	107,719
Less current maturities	23,494
	$ 84,225

Operating Leases

The Partnership leases the land and building of the dealership facility from an affiliate under an operating lease expiring in 19X7. Various other lease agreements also exist for equipment. Minimum future rental payments under the leases are as follows:

Years ending December 31,

19X3	$ 420,000
19X4	420,000
19X5	420,000
19X6	420,000
19X7	315,000
	$1,995,000

Rent expense on all operating leases was approximately $420,000 and $258,500 for 19X2 and 19X1, respectively. Additionally, the Partnership is liable for property taxes and insurance.

Consulting Fee Agreement

The Partnership, along with Pit Stop Crew, entered into an agreement at the inception of the Partnership with a consultant who advised them on certain matters relating to the purchase of the assets of the acquired dealerships, as well as the underlying real estate acquired by related entities. The consulting fee of $370,000 is to be paid, beginning May 19X1, by remitting $25 times the number of retail vehicles sold during each preceding month. Based on the current sales of vehicles during 19X2 and 19X1, the obligation is projected to be paid in full during 19X3.

Of the total fee of $370,000, the Partnership expects to pay approximately $215,500 ($87,900 and $76,850 paid in 19X2 and 19X1, respectively) and Pit Stop Crew, $110,950 ($66,900 and $44,050 paid in 19X2 and 19X1, respectively). The amount paid on behalf of the related real estate entities was reflected as a noncurrent asset in 19X1 and was repaid in full in 19X2.

Governmental Regulation

Substantially all of the Partnership's facilities are subject to federal, state and local regulations relating to the discharge of materials into the environment. Compliance with these provisions has not had, nor does the Partnership expect such compliance to have, any material effect upon the capital expenditures, net income, financial condition or competitive position of the Partnership. Management believes that its current practices and procedures for the control and disposition of such wastes comply with applicable federal and state requirements.

Guarantee

The Partnership, along with Pit Stop Crew, and the partners (on a limited basis), guarantees the obligations of certain affiliates of about $4,630,000.

Note 11 — Subsequent Event

In February 19X3, the Partnership entered into a new floor plan loan agreement with a bank to finance its new and demonstrator vehicle inventory.

11.400

Auto Dealership Financial Statement Disclosure and Auditor's Report Checklists

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS

These checklists have been developed especially for use in audits of auto dealership entities. Included are *only* (1) the disclosures typically required in financial statements of auto dealerships and (2) the reporting situations typically encountered in audits of auto dealerships. Accordingly, users should carefully consider the need to modify these checklists for any additional disclosure requirements and/or reporting situations encountered during the engagement.[1]

For each item, place a check mark (✓) in the "Yes," "No," or "N/A" (not applicable) column. Add additional explanations such as "N/M" (not material) if necessary.

Explanation of References:

APB	=	AICPA Accounting Principles Board Opinion
ARB	=	AICPA Accounting Research Bulletin
EITF	=	FASB Emerging Issues Task Force Consensuses
FASBI	=	FASB Interpretation
FASCON	=	FASB Statement of Financial Accounting Concepts
PB	=	AICPA Practice Bulletin
SAS	=	AICPA Statement on Auditing Standards
SFAS	=	FASB Statement of Financial Accounting Standards
SOP	=	AICPA Statement of Position
TB	=	FASB Technical Bulletin
TPA	=	AICPA Technical Practice Aids

GENERAL

	Yes	No	N/A
A. Titles and References			
1. Are the financial statements suitably titled? (SAS 62)	___	___	___

[1] The AICPA's *Checklists and Illustrative Financial Statements for Corporations* contains comprehensive checklists that include additional disclosures required for larger and more complex entities.

	Yes	No	N/A
2. Does each statement include a general reference to the notes? (FASCON 1)	___	___	___
3. Are the notes referenced to and from the applicable statement classification or appropriately captioned? (FASCON 1)	___	___	___
B. Disclosure of Accounting Policies [APB 22 (AC A10)]			
1. Is a description of all significant accounting policies presented?	___	___	___
2. Do the disclosures of significant accounting policies include those related to:			
a. Revenue recognition of finance and insurance income and the reserve for future finance and insurance chargebacks?	___	___	___
b. Transfers of receivables with recourse?	___	___	___
C. Comparative Financial Statements [ARB 43 (AC F43)]			
1. Have comparative statements been considered?	___	___	___
2. Are the notes and other disclosures included in the financial statements of the preceding year(s) presented, or referred to, to the extent that they continue to be of significance?	___	___	___
D. Business Combinations [APB 16 (AC B50)]			
1. If a business combination has occurred during the period, has the organization recorded this correctly, and made the required disclosures in the financial statements and notes?	___	___	___
E. Consolidations			
1. If consolidated statements are presented—			
a. Is the consolidation policy disclosed? [ARB 51 (AC C51); APB 22 (AC A10)]	___	___	___
b. When the financial reporting periods of subsidiaries differ from that of the parent, is the effect of intervening events that materially affect financial position or the results of operations recognized? [ARB 51 (AC C51)]	___	___	___

	Yes	No	N/A
F. Related-Party Transactions [SFAS 57 (AC R36)]			
1. For related-party transactions (including transactions with affiliates under common management), do disclosures include—			
a. The nature of the relationship?	___	___	___
b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed?	___	___	___
c. The dollar amounts of transactions for each income statement presented?	___	___	___
d. Amounts due from or to related parties as of each balance-sheet date and the terms and manner of settlement?	___	___	___
e. The information required by paragraph 49 of SFAS 109, *Accounting for Income Taxes*.	___	___	___
2. Is the nature of a controlled relationship disclosed if the control could result in operating results or financial position of the reporting entity being significantly different from what would have been reported if the entity were autonomous?	___	___	___
G. Financial Instruments			
SFAS 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets, for which it is effective for fiscal years ending after December 15, 1995. In addition to requiring disclosures related to derivatives, SFAS 119 expands and amends SFASs 105 and 107. [SFASs 105, 107, and 119]			
1. Are all disclosures (including contract amount, nature and terms, amount of accounting loss at risk, and the entity's policies) for all financial instruments (those with and without off-balance-sheet risk) included in the body of the financial statements or in the notes by category of financial instrument? [Refer to SFAS 105, pars. 17 and 18, as amended by SFAS 119, par. 14, and SFAS 119, pars. 8 and 9 for required disclosures.]	___	___	___
2. Are all significant concentrations of credit risk arising from all financial instruments disclosed?	___	___	___
3. Are all fair value disclosures made with regard to all financial instruments?	___	___	___

	Yes	No	N/A
4. Do the disclosures in Steps 1 and 3 distinguish between financial instruments held for trading purposes and those held for purposes other than trading?	___	___	___
5. If the offsetting of derivatives against nonderivatives is not permitted under FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, does the entity, when disclosing the fair value of derivatives, not combine, aggregate, or net the fair values?	___	___	___
6. Are all disclosures for derivatives held for purposes other than trading included in the financial statements? (Note: small businesses rarely hold derivatives for trading purposes; therefore, disclosures for such derivatives are not included in this checklist. If the entity holds derivatives for trading purposes, refer to SFAS 119 for required disclosures.)	___	___	___
H. Contingencies and Commitments/Risks and Uncertainties [SFAS 5 (AC C59), SOP 94-6]			
1. Are the nature and amount of loss contingencies properly disclosed (Most dealerships briefly describe the federal, state, and local regulations they are subject to, such as those for maintenance and use of underground storage tanks, as well as management's estimate of any liabilities associated with these regulations.)?	___	___	___
2. For loss contingencies not accrued, do disclosures indicate—			
a. The nature of the contingency?	___	___	___
b. An estimate of possible loss or range of loss, or a statement that such estimate cannot be made?	___	___	___
3. Are the nature and amount of guarantees disclosed (for example, guarantee of indebtedness of others, and guarantees to repurchase receivables that have been sold or otherwise assigned)?	___	___	___
4. Are gain contingencies adequately disclosed with care to avoid any misleading implications about the likelihood of realization?	___	___	___
5. Do the financial statements include the following disclosures about risks and uncertainties?			
a. Nature of operations.	___	___	___
b. Use of estimates in the preparation of financial statements.	___	___	___

	Yes	No	N/A
c. Certain significant estimates (if certain conditions are met).	___	___	___
d. Current vulnerability due to certain concentrations (if certain conditions are met).	___	___	___
6. Is there adequate disclosure of commitments, such as those for capital expenditures, restrictive covenants in financing agreements, inventory purchase agreements, and employment contracts?	___	___	___
I. Subsequent Events [SAS 1]			
1. Are the financial statements adjusted for the effects of any subsequent events related to conditions that existed at the balance-sheet date?	___	___	___
2. Are any subsequent events related to conditions that did not exist at the balance-sheet date, but arose after that date, disclosed?	___	___	___
J. Limited Liability Companies (LLCs) [PB14]			
1. Are the financial statements clearly identified as being those of an LLC?	___	___	___
2. If the LLC has a finite life, do disclosures include the date the LLC will cease to exist?	___	___	___
3. Do disclosures include:			
a. A description of any limitation of an LLC member's liability?	___	___	___
b. The different classes of member's interest and the respective rights, preferences, and privileges of each class?	___	___	___
4. Are all disclosures regarding members' equity and changes in members' equity for the period made?	___	___	___
5. Are all disclosures relating to the conversion of the entity to an LLC made?	___	___	___
K. Other Matters			
1. Are material changes in the current financial statement classifications and conforming reclassifications in prior period comparative statements indicated and explained in the financial statements or notes? [SAS 1]	___	___	___

	Yes	No	N/A
2. Postretirement Benefits Other Than Pensions (SFAS 106)[1]			
a. If there are one or more defined benefit postretirement plans, do disclosures include—			
(1) A description of the substantive plan(s) that is (are) the basis for the accounting?	___	___	___
(2) The amount of net periodic postretirement benefit cost?	___	___	___
(3) A schedule reconciling the funded status of the plan(s) with amounts reported in the employer's statement of financial position?	___	___	___
(4) The assumption and rates used in computing the expected postretirement benefit obligation and the accumulated postretirement benefit obligation (APBO) including the assumed health care cost trend rates; assumed discount rates; and the effect of a one-percentage-point increase in the assumed health care cost trend rate on the measurement of the APBO, the service cost, and the interest cost?	___	___	___
(5) The amounts and types of securities of the employer and related parties included in plan assets and the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer and related parties?	___	___	___
(6) Any alternative amortization method used pursuant to paragraphs 53 or 60 of SFAS 106?	___	___	___
(7) The amount of gain or loss recognized during the period for a settlement or curtailment and a description of the nature of the event(s)?	___	___	___
(8) The cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event(s)?	___	___	___

[1] The following disclosures are based on SFAS 106, which is for fiscal years beginning after December 15, 1992, except for plans outside the United States and for defined-benefit plans of employers that (1) are nonpublic entities and (2) sponsor defined-benefit postretirement plan(s) with no more than 500 plan participants in the aggregate, in which case the effective date shall be for fiscal years beginning after December 15, 1994. Earlier application is encouraged. If SFAS 106 has not yet been adopted, SFAS 81 should be followed.

	Yes	No	N/A
b. If there are one or more defined-contribution postretirement plans, are the following items disclosed separately from defined benefit postretirement plan disclosures?			
(1) A description of the plan(s).	___	___	___
(2) The amount of cost recognized during the period.	___	___	___
c. If an obligation for postemployment benefits is not accrued in accordance with SFAS 5 or 43 only because the amount cannot be reasonably estimated, is that fact disclosed in the financial statements? [SFAS 112 (AC P32)]	___	___	___
d. If SFAS 106 has not been adopted, are health care or life insurance benefits provided to retirees, their dependents, or survivors properly disclosed? [SFAS 81 (AC P50)]	___	___	___
3. If required by SFAS 21, does the financial statement presentation include segment information? [SFAS 14, as amended by SFAS 21; SFAS 24; SFAS 30 (AC S20)]	___	___	___

L. Pension Plans

(For defined benefit plans, the accounting and reporting by the plans should be in conformity with SFAS 35).

	Yes	No	N/A
1. If there is a defined benefit plan, do disclosures include—			
a. A description of the plan(s)?	___	___	___
b. The amount of net periodic pension cost?	___	___	___
c. All amounts shown within three months of the balance-sheet date using a consistent date from year to year?	___	___	___
d. A schedule reconciling the funded status of the plan(s) with amounts reported in the employer's statement of financial position, including—			
(1) The fair value of plan assets?	___	___	___
(2) The projected benefit obligation identifying the accumulated benefit obligation and the vested benefit obligation?	___	___	___
(3) The amount of unrecognized prior service cost?	___	___	___

	Yes	No	N/A
(4) The amount of unrecognized net gain or loss?	___	___	___
(5) The amount of any remaining unrecognized net obligation or net asset existing at the date of initial application of SFAS 87?	___	___	___
(6) The amount of any additional liability recognized pursuant to SFAS 87, paragraph 36?	___	___	___
(7) The amount of net pension asset or liability recognized in the statement of financial position pursuant to SFAS 87, paragraphs 35–36 (which is the net result of combining the preceding six items)?	___	___	___
e. The weighted-average assumed discount rate and rate of compensation increase used to measure the projected benefit obligation and the weighted-average expected long-term rate of return on plan assets?	___	___	___
f. The amount and types of securities of the employer and related parties included in plan assets, and the approximate amount of annual benefits of employees and retirees covered by annuity contracts issued by the employer and related parties, the alternative amortization methods used pursuant to SFAS 87, paragraphs 26 and 33, and the existence and nature of the commitment discussed in paragraph 41?	___	___	___
g. If applicable, the alternative amortization methods used pursuant to SFAS 87, paragraphs 26 and 33 [AC P16.120 and .127], and the existence and nature of the commitment discussed in paragraph 41?	___	___	___
h. If more than one defined benefit plan exists:			
(1) Have the disclosures required by step 1 above been aggregated for all of the employee's single employer defined benefit plans or disaggregated in groups so as to provide the most useful information?	___	___	___
(2) Are plans with assets in excess of accumulated benefit obligation not aggregated with plans that have accumulated benefit obligations that exceed plan assets?	___	___	___
(3) Are disclosures for plans outside the U.S. not combined with those for U.S. plans unless those plans use similar economic assumptions?	___	___	___

[SFAS 87 (AC P16)]

	Yes	No	N/A
2. If there is a defined contribution plan, do disclosures include:			
a. A description of the plan(s)?	___	___	___
b. The amount of cost recognized during the period?	___	___	___
c. If the pension plan has characteristics of both a defined benefit plan and a defined contribution plan:			
(1) Is the substance of the plan to provide a defined benefit?	___	___	___
(2) Are accounting and disclosure requirements in accordance with the provisions of Step 1 above? [SFAS 87 (AC P16)]	___	___	___
3. If there is a multiemployer plan, do disclosures include:			
a. A description of the multiemployer plan(s)?	___	___	___
b. The amount of cost recognized during the period?	___	___	___
c. Have the provisions of SFAS 5 been applied if the situation arises where the withdrawal from a multiemployer plan may result in the employer having an obligation to the plan for a portion of its unfunded benefit obligations which is either probable or reasonably possible? [SFAS 87 (AC P16)]	___	___	___
4. If there is a settlement, curtailment, or termination of benefits under such a plan, do disclosures include—			
a. A description of the event(s)?	___	___	___
b. The amount of gain or loss recognized? [SFAS 88 (AC P16)]	___	___	___

BALANCE SHEET

A. General

	Yes	No	N/A
1. For classified balance sheets, are assets and liabilities segregated into current and noncurrent classifications with totals presented for current assets and current liabilities? [ARB 43, SFAS 6, FASBI 8, TB 79-3 (AC B05)]	___	___	___

	Yes	No	N/A
2. Are assets not expected to be realized during the current operating cycle classified as noncurrent? [ARB 43 (AC B05)]	___	___	___
3. Are valuation allowances contra to such assets as receivables shown as deductions from their related assets with appropriate disclosure? (APB 12)	___	___	___
B. Cash			
1. Is restricted cash segregated from cash available for current operations and properly disclosed? [ARB 43 (AC B05)]	___	___	___
C. Investment Securities [SFAS 115 (AC I80)]			
1. For investment securities classified as available-for-sale and as held-to-maturity, do disclosures include—			
a. Aggregate fair value for the latest balance sheet presented?	___	___	___
b. Gross unrealized gains and gross unrealized losses for the latest balance sheet presented?	___	___	___
c. Amortized cost basis by major security type for each balance sheet presented?	___	___	___
d. Contractual maturities of debt securities for the latest balance sheet presented?	___	___	___
e. Information about sales, cost, and realized and unrealized gains and losses for each income statement presented?	___	___	___
2. Are significant net realized and net unrealized gains and losses that arose after the latest balance-sheet date but before issuance of the financial statements disclosed?	___	___	___
3. Are valuation allowances deducted from their related portfolios with appropriate disclosure?	___	___	___
D. Receivables			
1. Are accounts and notes receivable from officers, employees, and affiliated companies shown separately with appropriate disclosures? [ARB 43 (AC R36)]	___	___	___

	Yes	No	N/A
2. Are unbilled receivables (for example, unbilled costs and fees under cost-plus-fixed-fee contracts) shown separately from billed receivables? [ARB 43 (AC R36)]	___	___	___
3. Are allowances for uncollectible receivables shown as deductions from the related receivables? [APB 12 (AC V18)]	___	___	___
4. Are unearned finance charges and interest included in the face amounts of receivables shown as a deduction from the related receivables? [APB 6 (AC B05)]	___	___	___
5. For transfers of receivables with recourse that are reported as sales, are the following disclosed—			
a. The proceeds to the transferors during each period for which an income statement is presented?	___	___	___
b. Information required by paragraphs 17, 18, and 20 of SFAS 105? [SFAS 77 (AC R20)]	___	___	___
6. If the entity has extended a loan that is impaired, are the disclosures required by SFAS 114, as amended by SFAS 118, included in the financial statements? [SFAS 114 and 118 (AC I08)]	___	___	___
E. Inventories			
1. Are the major classes of inventory disclosed (for example, new vehicles and demonstrators, used vehicles, parts and accessories, rental vehicles, etc.)? [ARB 43 (AC B05)]	___	___	___
2. Is the method of determining inventory cost (for example, LIFO, FIFO) disclosed? [ARB 43 (AC I78)]	___	___	___
3. Is the basis for recording inventory disclosed (for example, lower of cost or market)? [ARB 43 (AC I78)]	___	___	___
4. Are valuation allowances for inventory losses shown as a deduction from the related inventory? [APB 12 (AC V18)]	___	___	___
5. For dealerships using the last-in, first-out (LIFO) method, do disclosures include the LIFO Reserve or replacement cost and its basis for determination? (TPA Section 2140.14)	___	___	___

	Yes	No	N/A
F. Investments [APB 18 (AC I82)]			
1. Is the equity method used to account for investments in the common stock of—			
a. Corporate joint ventures?	___	___	___
b. Investees in which the entity has an "ability to exercise significant influence" (generally presumed to be 20% or more of the voting stock)?	___	___	___
2. Are the appropriate disclosures made for investments in common stock accounted for by the equity method?	___	___	___
G. Property and Equipment			
1. For depreciable assets, do disclosures include—			
a. Depreciation expense for each income statement presented?	___	___	___
b. Balances of major classes of depreciable assets by nature or function?	___	___	___
c. Accumulated depreciation, either by major class of assets or in total?	___	___	___
d. Depreciation methods for each major class of depreciable assets? [APB 12 (AC D40)]	___	___	___
2. Are net assets and liabilities of discontinued segments segregated from the assets and liabilities of continuing operations? [APB 30 (AC I13)]	___	___	___
3. If SFAS 121 has been adopted, have the following disclosures been included in the financial statements?	___	___	___
a. Disclosures required if an impairment loss is recognized for assets to be held or used, such as a description of the assets and impairment, amount of impairment, how the fair value was determined, and the income statement caption in which the impairment loss is aggregated. [SFAS 121, par. 14]	___	___	___
b. Disclosures required for assets disposed of in accordance with paragraphs 15-19 of SFAS 121, such as a description and carrying amount of the assets, the loss resulting from application of paragraph 15, the gain or loss resulting from the application of paragraph 17, the income statement caption in which the gains or losses are aggregated, and the results of operations for the assets. [SFAS 121, pars. 15, 17, and 19]	___	___	___

	Yes	No	N/A
c. If an impairment loss is recognized, is it reported as a component of income from continuing operations before income taxes? [SFAS 121, pars. 13 and 18]	___	___	___
H. Lessors [SFAS 13 and SFAS 91 (AC L10)]			
1. For sales-type and direct financing leases, do disclosures include—			
a. Components of net investment in leases?	___	___	___
b. Future minimum lease payments to be received for each of the next five years?	___	___	___
c. Total contingent rentals included in income for each income statement presented?	___	___	___
d. The amount of initial direct costs for direct financing leases?	___	___	___
2. For operating leases, do disclosures include—			
a. Cost and carrying amounts of leased property by major class and the amount of accumulated depreciation?	___	___	___
b. Minimum future rentals in the aggregate and for each of the next five years?	___	___	___
c. Total contingent rentals included in income for each income statement presented?	___	___	___
3. Do disclosures include a general description of the lessor's leasing arrangements?	___	___	___
4. Are leveraged leases appropriately accounted for and reported?	___	___	___
I. Other Assets and Deferred Charges (AC I60 and I27)			
1. Are the costs of intangible assets acquired from other entities recorded as assets? (APB 17)	___	___	___
2. Do disclosures include the method and period of amortization? (APB 17)	___	___	___
3. Are the costs of developing, maintaining or restoring intangible assets that are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to the entity as a whole, expensed when incurred? (APB 17)	___	___	___

	Yes	No	N/A
4. Are issue costs of debt reported as deferred charges? (APB 21)	___	___	___
5. Are deferred tax assets for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction presented separately? (SFAS 109)	___	___	___
6. Are deferred tax assets classified as current or noncurrent based on the classification of the related asset, and are deferred tax assets not related to an asset classified according to the expected reversal date of the temporary difference? (SFAS 109)	___	___	___
7. Have the following items been offset and presented as a single amount for a particular tax paying component and within a particular tax-paying jurisdiction? (SFAS 109)			
a. All current deferred tax liabilities and assets.	___	___	___
b. All noncurrent deferred tax liabilities and assets.	___	___	___
8. Are the components of the total of all deferred tax assets and valuation allowances reported in the balance sheet disclosed? (SFAS 109)	___	___	___
9. Has any valuation allowance for deferred tax assets been allocated between current and noncurrent deferred tax assets on a pro rata basis? (SFAS 109)	___	___	___
10. Has an asset (prepaid pension cost) been recognized if net periodic pension cost is less than amounts the employer has contributed to the plan? (SFAS 87)	___	___	___
11. If an additional minimum liability has been recognized pursuant to SFAS 87, has an equal amount been recognized as an intangible asset, provided that the asset recognized does not exceed the amount of unrecognized prior service cost? (SFAS 87)	___	___	___
12. Is any payment by an S Corporation to the IRS to retain its fiscal year for tax purposes classified as an asset (deposit)? (EITF 88-4)	___	___	___
J. Current Liabilities			
1. Do current liabilities include—			
a. Obligations for items that have entered the operating cycle?	___	___	___

	Yes	No	N/A
b. Collections received in advance of the delivery of goods or performance of services?	___	___	___
c. Debts that arise from operations directly related to the operating cycle?	___	___	___
d. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short time period?	___	___	___
e. Obligations that, by their terms, are due on demand or will be due within one year (or operating cycle, if longer) from the balance-sheet date? [ARB 43 and SFAS 78 (AC B05)]	___	___	___
2. Do current liabilities exclude short-term obligations that the entity intends to refinance on a long-term basis, provided the entity has demonstrated the ability to consummate the long-term financing? [SFAS 6 (AC B05)]	___	___	___
K. Floor Plan Notes Payable and Other Debt			
1. Are interest rates, maturities, assets pledged as collateral, and other terms and conditions provided in financing agreements, (including the terms for repayment of floor plan notes and interest, and available financing under floor plan lines of credit), properly disclosed? (SFAS 5, FASCON 6)	___	___	___
2. Are the amounts of fixed maturities for all long-term borrowings disclosed in the aggregate and for each of the next five years? [SFAS 47 (AC C32)]	___	___	___
3. If the note is noninterest bearing or has an inappropriate stated interest rate—			
a. Is the discount or premium presented as a deduction from or addition to the face amount of the note?	___	___	___
b. Does the disclosure include the effective interest rate and face amount of the note?	___	___	___
c. Is amortization of the discount or premium reported as interest in the income statement?	___	___	___
d. Are issue costs reported in the balance sheet as deferred charges? [APB 21 (AC I69)]	___	___	___

	Yes	No	N/A
4. Are conversion features appropriately accounted for and disclosed? [APB 14 (AC D10)]	___	___	___
5. Are current portions of debt obligations presented as current liabilities? [ARB 43 (AC B05)]	___	___	___
6. If a short-term obligation is to be excluded from current liabilities per SFAS 6, do disclosures include:			
a. A general description of the financing agreement?	___	___	___
b. Terms of any new obligation incurred or expected to be incurred, or equity securities issued or expected to be issued as a result of the refinancing? [SFAS 6 (AC B05)]	___	___	___
7. Has debt been considered extinguished for reporting purposes when:			
a. The debtor is legally released from being the primary obligor and it is probable that the debtor will not be required to make future payments with respect to that debt under any guarantee?	___	___	___
b. The debtor irrevocably places cash or other assets in a trust to be used solely for satisfying scheduled payments of both interest and principal of a specific obligation and the possibility that the debtor will be required to make future payments with respect to that debt is remote? [SFAS 76 (AC D14)]	___	___	___
L. Lessees [SFAS 13 (AC L10)]			
1. For capital leases, do disclosures include a general description of the lessee's leasing arrangements and—			
a. Identification of gross amounts of assets recorded by major classes and the related accumulated amortization and obligations under the lease, and amortization expense (unless it is included in depreciation expense and disclosed as such)?	___	___	___
b. Future minimum lease payments, in the aggregate and for each of the next five years, with deductions for executory costs and imputed interest?	___	___	___
c. Total of future minimum sublease rentals under noncancelable subleases?	___	___	___

	Yes	No	N/A
d. Total contingent rentals incurred for each income statement presented?	___	___	___
e. Assets recorded under capital leases, either in the balance sheet or the notes?	___	___	___
2. For operating leases that have initial or remaining noncancelable lease terms in excess of one year, do disclosures include—			
a. Future minimum rental payments required in the aggregate and for each of the next five years?	___	___	___
b. Total of future minimum rentals under noncancelable subleases?	___	___	___
3. For all operating leases, do disclosures include rental expense for each income statement presented with separate amounts for minimum rentals, contingent rentals, and sublease rentals?	___	___	___
4. Do disclosures include a general description of the lessee's leasing arrangements including—			
a. Basis for determination of contingent rentals?	___	___	___
b. Terms of any renewal, purchase options, or escalation clauses?	___	___	___
c. Restrictive covenants?	___	___	___
M. Other Liabilities and Deferred Credits [AC I27, In6, C59, C44, P16]			
1. Have deferred tax liabilities determined for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction been presented separately? (SFAS 109)	___	___	___
2. Have deferred tax liabilities been classified as current or noncurrent based on the related asset or liability? (SFAS 109)	___	___	___
3. Have deferred tax liabilities not related to an asset or liability been classified according to the expected reversal date of the temporary difference pursuant to SFAS 37? (SFAS 109)	___	___	___
4. Have the components of the total of all deferred tax liabilities recognized in the balance sheet been disclosed? (SFAS 109)	___	___	___
5. Are estimated loss contingencies accrued if they are probable and the amount can be reasonably estimated? (SFAS 5 and FASBI 14)	___	___	___

	Yes	No	N/A
6. Are liabilities appropriately accrued and reported for employees' compensation for future absences? (SFAS 43)	___	___	___
7. Are liabilities for special termination benefits to employees accrued and reported when the employees accept the offer and the amount can be reasonably estimated? (SFAS 88)	___	___	___
8. Has a liability (unfunded accrued pension cost) been recognized if net periodic pension cost recognized, pursuant to SFAS 87, exceeds amounts the employer has contributed to the plan? (SFAS 87)	___	___	___
9. If the accumulated benefit obligation exceeds the fair value of the pension plan's assets, has the employer recognized a liability (including unfunded accrued pension cost) that is at least equal to the unfunded accumulated benefit obligation? (SFAS 87)	___	___	___
10. Has an additional minimum liability been recognized in accordance with the provisions of SFAS 87, paragraph 36? (SFAS 87)	___	___	___
N. Stockholders' Equity			
1. For each class of stock, do disclosures include the number of shares authorized, issued and outstanding, and par or stated value per share? [APB 12 (AC C08)]	___	___	___
2. Are restrictions on payment of dividends disclosed? [SFAS 5 (AC C59)]	___	___	___
O. Changes in Stockholders' Equity			
1. Are changes in the components of, and number of shares of stockholders' equity disclosed? [APB 12 (AC C08)]	___	___	___
2. Are prior-period adjustments and their resulting effects (both gross and net of applicable income taxes) appropriately disclosed? [APB 9 (AC A35)]	___	___	___
3. For a correction of an error, are the following disclosed in the period in which the error was discovered and corrected?			
a. Nature of the error.	___	___	___
b. Effect of its correction on income before extraordinary items, net income, and related per share amounts (if applicable). (APB 20)	___	___	___

Yes No N/A

INCOME STATEMENT

A. Revenues and Expenses

1. Are the important components of income separately disclosed, such as—

   a. Interest expense? [SFAS 34 (AC I67)] ___ ___ ___

   b. Income taxes? [SFAS 109 (AC I27)] ___ ___ ___

   c. Sales or other sources of revenue, cost of sales, and selling and administrative expenses? [SFAS 89 (AC C28)] ___ ___ ___

2. For debt and marketable equity securities classified as available-for-sale or held-to-maturity, are the following disclosures made, by major security type, for each balance sheet presented?

   a. Aggregate fair value. ___ ___ ___

   b. Gross unrealized holding gains and losses. ___ ___ ___

   c. Amortized cost basis. ___ ___ ___

   [SFAS 115 (AC I80)]

3. For investments in debt securities classified as available-for-sale or held-to-maturity is disclosure made about their contractual maturities as of the latest balance-sheet date presented? [SFAS 115 (AC I80)] ___ ___ ___

4. For each income statement are the following disclosures made?

   a. The proceeds from sales of available-for-sale securities and gross realized gains and losses on those sales. ___ ___ ___

   b. The basis on which cost was determined in computing realized gain or loss. ___ ___ ___

   c. The gross gains and losses included in earnings from transfers of securities from the available-for-sale category to the trading category. ___ ___ ___

   d. The change in net unrealized holding gain or loss on available-for-sale securities. ___ ___ ___

   e. The change in net unrealized holding gain or loss on trading securities. ___ ___ ___

   [SFAS 115 (AC I80)]

	Yes	No	N/A
5. For any sales or transfers of held-to-maturity securities, is disclosure made of the following for each income statement presented?			
a. Amortized cost amount of the sold or transferred security.	___	___	___
b. Related realized or unrealized gain or loss.	___	___	___
c. The circumstances leading to the decision to sell or transfer the security. [SFAS 115 (AC I80)]	___	___	___
6. For investments in common stock accounted for by the equity method [APB 18 (AC I82)]:			
a. Are intercompany profits and losses eliminated?	___	___	___
b. Is the investor's share of earnings shown as a single amount?	___	___	___
7. Is the amount of interest expense disclosed in the statements or notes thereto, and the amount that has been capitalized, if any? [SFAS 34 (AC I67)]	___	___	___
8. Is discount or premium on notes receivable and payable amortized to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period (the interest method) and reported as interest? (APB 12, APB 21)	___	___	___
9. Is the cost of the pension plan(s) accounted for in conformity with SFAS 87? (SFAS 87)	___	___	___
10. Have settlements of defined benefit pension plans been accounted for in accordance with SFAS 88? (SFAS 88)	___	___	___
11. Have curtailments of defined benefit pension plans been accounted for in accordance with SFAS 88? (SFAS 88, pars. 6 and 12–14)	___	___	___
a. Have such settlements and curtailments been properly differentiated in accordance with SFAS 88? (SFAS 88, pars. 7–8)	___	___	___
12. Have termination benefits been accounted for in accordance with SFAS 88? (SFAS 88, par. 15)	___	___	___
13. Has the gain or loss measured in accordance with SFAS 88 that is directly related to a disposal of a segment of a business, been included in determining the gain or loss associated with that event, and recognized in accordance with APB 30? (SFAS 88)	___	___	___

	Yes	No	N/A
14. For a transfer of receivables with recourse, has a sale been recognized if all of the conditions specified in SFAS 77 are met? (SFAS 77)	___	___	___
B. Income Taxes [SFAS 109 (AC I27)]			
1. Have the types of significant temporary differences and carryforwards been disclosed?	___	___	___
2. Are the significant components of income tax expense (such as current and noncurrent income tax expense) attributable to continuing operations for each year presented disclosed?	___	___	___
3. Is the amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items disclosed for each year for which those items are presented?	___	___	___
4. Is the nature of significant reconciling items disclosed?	___	___	___
5. Have the amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes been disclosed?	___	___	___
6. If the entity is a member of a group that files a consolidated tax return, have the following items been disclosed in its separately issued financial statements:			
a. The aggregate amount of current and deferred tax expense?	___	___	___
b. The amount of any tax-related balances due to or from affiliates?	___	___	___
c. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method?	___	___	___
C. Extraordinary Items [APB 30 (AC I17)]			
1. Do extraordinary items meet both criteria of (a) an unusual nature and (b) infrequency of occurrence?	___	___	___
2. Are extraordinary items segregated and shown (including applicable income taxes) following income before extraordinary items and before net income?	___	___	___
3. Do disclosures include a description of the extraordinary event or transaction and the principal items entering into determination of extraordinary gain or loss?	___	___	___
4. Are material events that are unusual or infrequent reported as a separate component of income from continuing operations and adequate disclosures made?	___	___	___

	Yes	No	N/A

STATEMENT OF CASH FLOWS [SFAS 95 (AC C25)]

A. Format

1. Is a statement of cash flows presented for each period for which an income statement is presented? ___ ___ ___

2. Is the change in cash and cash equivalents presented? ___ ___ ___

3. Is the definition of a cash equivalent disclosed (Most dealerships consider contracts in transit as a cash equivalent.)? ___ ___ ___

4. Are major classes of gross cash receipts and payments and their sum [net cash flow from operating activities (direct method)] presented? ___ ___ ___

5. If the direct method is used, is a reconciliation of net income to net cash flow from operating activities provided in a separate schedule? ___ ___ ___

6. If the indirect method is used, has the same amount for net cash flow from operating activities been reported indirectly by reconciling net income to net cash flow from operating activities? ___ ___ ___

7. If the indirect method is used, has the reconciliation of net income to net cash flow from operating activities been reported either within the statement of cash flows or provided in a separate schedule, with the statement of cash flows reporting only the net cash flow from operating activities? ___ ___ ___

B. Content

1. Are cash receipts and payments for transactions, such as making and collecting loans and acquiring and selling property, classified as cash flows from investing activities? ___ ___ ___

2. Are cash receipts and payments for transactions, such as obtaining resources from owners, borrowing money, and repaying amounts owed, classified as cash flows from financing activities? ___ ___ ___

3. Are cash receipts and payments for transactions for all other events, such as producing and delivering goods and providing services, classified as cash flows from operating activities? ___ ___ ___

4. Are noncash investing and financing activities summarized on a separate schedule? ___ ___ ___

Auditors' Report Checklist

	Yes	No	N/A
1. Does the auditor's report include the appropriate—			
a. Addressee? [SAS 58, par. 9 (AU 508.09)]	___	___	___
b. Date (or dual dates) of the report? [SAS 1, Sec. 530.05 (AU 530.05)]	___	___	___
2. Does the reporting language conform with the auditor's standard report as prescribed by SAS No. 58?	___	___	___
3. Does the report include appropriate modifying language for the following situations?			
a. The inability to apply the auditing procedures considered necessary in the circumstances (scope limitation). [SAS 31, par. 23 (AU 326.23)]	___	___	___
b. The financial statements do not conform with generally accepted accounting principles (including inadequate disclosure). [SAS 58, pars. 49-66 (AU 508.49-.66)]	___	___	___
c. The financial statements are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation.[1] [SAS 58, pars. 16-33 (AU 508.16-.33)]	___	___	___
d. There is substantial doubt about the entity's ability to continue as a going concern. [SAS 64, par. 1 (AU 341.12-.13)]	___	___	___
e. There has been a material change between periods in accounting principles or in the method of their application. [SAS 58, pars. 34-36 (AU 508.34-.36)]	___	___	___
f. In an updated report on comparative financial statements, the opinion on the prior period is different from the one previously expressed. [SAS 58, pars. 77-78 and 81-82 (AU 508.77-.78 and .81-.82)]	___	___	___
g. A matter regarding the financial statements needs to be emphasized.	___	___	___
h. Part of the financial statements was audited by another auditor, and we are relying on the other auditor's work. [SAS 1 (AU 543)]	___	___	___

[1] At press time, an exposure draft of a proposed amendment to SAS 58 had been released that would eliminate the requirement to add an explanatory paragraph for certain uncertainties. To obtain the latest information on this amendment, call the AICPA Technical Hotline at 800-862-4272.

	Yes	No	N/A
i. Prior-period financial statements are presented for comparative purposes, and they were—			
(1) Audited by a predecessor auditor whose report is not presented. [SAS 64, par. 2 (AU 508.83)]	___	___	___
(2) Reviewed or compiled by us, or a predecessor accountant whose report is not presented. [SAS 26, pars. 14-17 (AU 504.14-.17)]	___	___	___

11.500

Financial Statement Control Form

Client: ____________________

Financial Statement Date: ____________________

INSTRUCTIONS: This form should be prepared by the In-charge to accompany the draft of the financial statements and report. Each step should be initialed and dated as it is completed, or checked "N/A." Step 8 must be initialed and dated by the engagement partner in order to release the financial statements and report.

	Performed by		
	Initials	**Date**	**N/A**
1. Submit financial statements and report to typing.	______	______	☐
2. Proofread the financial statements and report.	______	______	☐
3. Resubmit the financial statements and report for correction.	______	______	☐
4. Submit to technical reviewer, if applicable.	______	______	☐
5. Resubmit the financial statements and report for corrections.	______	______	☐
6. Foot and crossfoot all pages.	______	______	☐
7. Submit to engagement partner for final review.	______	______	☐
8. Release the financial statements and report.	______	______	

Number of Copies:

Bound: __________ Unbound: __________

Other: ____________________

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Auto Dealership Industry
Advisory Services

CHAPTER 12

THE AUTO DEALERSHIP INDUSTRY — ADVISORY SERVICES

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THE AUTO DEALERSHIP INDUSTRY — ADVISORY SERVICES

Table of Contents (Continued)

CHAPTER 12

THE AUTO DEALERSHIP INDUSTRY - ADVISORY SERVICES

12.000 ADDITIONAL OPPORTUNITIES

12.001 The auto dealership industry provides ample opportunities for accountants beyond the traditional audit, compilation, review, and tax services. Primary among these additional services is the accountant's role as a consultant.

12.002 The Statement on Standards for Consulting Services No. 1, *Consulting Services: Definitions and Standards* (SSCS No.1), incorporates the standards that the accountant must follow for consultation engagements. SSCS No. 1 defines consulting services as, "professional services that employ the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process." Consulting services may include one or more of the following: consultations, advisory services, implementation services, transaction services, staff and other support services, and product services. This chapter is intended to highlight certain advisory services that the accountant can provide.

12.003 SSCS No. 1 defines advisory services as one in which "...the practitioner's function is to develop findings, conclusions, and recommendations for client consideration and decision making." Examples include an operational review and improvement study and an analysis of an accounting system.

12.004 The services that the accountant can perform for the auto dealer that fall under the purview of advisory services include reviewing the dealership's current management practices for potential waste as well as benchmarking the dealership's current profit and expense structure. In addition, the accountant can conduct a review of the dealership's compliance with current state and federal regulations to minimize potential future liabilities.

12.005 Certain of these services can be performed as part of an audit engagement with the results included in the auditor's management comment letter. However, many of the procedures discussed in this chapter may be incorporated into a separate consulting engagement. An example of a report resulting from a separate consulting engagement is included in Section 12.400. This chapter gives the accountant the tools to provide these additional services.

12.100 REVIEWING CURRENT MANAGEMENT PRACTICES AND OPERATIONS

12.101 This section is intended to highlight the most critical areas in which auto dealerships may be losing income due to inadequate management practices and/or controls. It is not intended to evaluate all of the internal controls or operations of the dealership.

12.102 In addition, this section is geared towards providing the accountant with guidance towards recognizing advisory service opportunities. In fact, many of the "red flags" enumerated below, which may be ascertained during an audit engagement, may lead to additional work.

12.103 A review of current management practices and operations involves an assessment of dealership procedures, internal controls, and other management areas to ensure that they work efficiently. This review includes procedures that enable the accountant to identify deficiencies in dealership operations. The objective of this review is to provide recommendations that will improve profitability by increasing efficiency.

12.104 Throughout this section, certain fundamental management controls are emphasized. In some cases, a step-by-step approach is provided to test the efficiency of these controls. An example of this approach is testing how long it takes for the paperwork on a completed car sale to reach the accounting department (sections 12.110 through 12.112). In other cases, where no particular testing is needed to determine inefficiency, only the controls are mentioned. An example of this is section 12.113, which notes that a dealership should generally not carry more than a 30-day supply of used cars.

New Car Department

12.105 **Purchases.** Management must always be cognizant as to which models are selling and be able to predict the peak and slow selling times of the year. The monthly dealer financial statement which is sent to the manufacturer provides a breakdown of the various models sold for the month and for the year to date. This information can be cross-referenced to the inventory held, enabling management to determine the specific models in which they are over- or under-stocked. With this knowledge, management can determine the appropriate models and quantities.

12.106 **Inventory Control.** As noted in section 2.403, the general rule of thumb is that a dealership should carry a 45-day supply of new cars. This practice covers the new car inventory taken as a whole. The dealership, though, maintains its new car inventory records on a specific identification basis in the new car inventory schedule. The new car inventory schedule, which is the dealership's perpetual inventory record, lists every new vehicle in inventory, usually in stock number order. Also, the information usually includes the date that the vehicle was stocked in and the number of days elapsed from that date.

12.107 A listing of all new cars in inventory for longer than 90 or 120 days along with the cost of floor plan interest over that period of time supplies management with concrete evidence of the necessity of selling these specific vehicles. The problem becomes more acute once the new model year begins.

12.108 Section 2.305 states that it is not unusual for a dealership's entire new vehicle inventory to be 100% financed. New cars in inventory that are not on floor plan represents cash tied up in inventory, while a floor plan liability for a new car no longer in inventory may represent an out of trust situation. Management should be constantly aware as to whether there are any cars in inventory that are not on floor plan or vice versa.

12.109 **Sales.** There is generally a central location where the paperwork for all car deals (new and used) end up prior to being sent to the accounting department. In most dealerships, this location is the F&I department. In addition to selling the customer financing and insurance, the personnel in the F&I department are responsible for ensuring that all necessary executed documentation is in the deal folder.

12.110 Once the vehicle is delivered to the customer, the completed deal folder should reach the accounting department within three days. If the vehicle was purchased by cash and/or a trade-in, any delay in the deal folder getting to the accounting department results only in a delay in the recording of the sale. However, if the vehicle was financed through the dealership, a delay could cost the dealership. As noted in section 3.122, the dealership receives the proceeds within a few days from delivery of the contract to the lender. The longer it takes for the deal folder to reach accounting, the longer it is before the contract itself can be sent to the lender.

12.111 A test that the accountant can perform is to take a copy of the month-do-date delivery log (as described in section 3.116) and determine which deal jackets have yet to reach accounting for vehicles sold three or more days earlier. By factoring in an interest rate based on the dealership's borrowing rate, an actual cost can be computed that illustrates how much the dealership is losing from delays in its paper flow. Any problem in this area becomes more significant if the vehicle's floor plan liability has already been paid.

12.112 Even if deal jackets reach accounting timely and the contracts are promptly sent to the lender, the dealership may experience delays in receiving the proceeds. A review of the contracts in transit schedule will reveal the age of all outstanding contracts. The accountant's role can be to illustrate to management the cost of not promptly collecting these proceeds and to highlight primary reasons for delays. For example, lenders will not accept contracts if the required attachments are incomplete. If contracts are being submitted to the lender incomplete, then the proceeds from those contacts will remain outstanding until the contracts are re-submitted to the lender with the appropriate attachments. At the very least, management should be receiving a listing of all contracts in transit older than 7 days in order to perform proper follow-up and to maintain control over these assets.

Used Car Department

12.113 Purchases. As noted in section 3.203, in addition to acquiring used cars through customer trade-ins, used cars may be purchased from other dealers or auctions in order to provide better balance to the used car inventory. Good management practices in this area may include the following:

- Chart every vehicle purchased from another dealer or auction to the ultimate customer

  Ideally, the used car department should be able to retail (at an appropriate gross profit) every vehicle that is purchased from another dealer or auction. However, there may be instances when certain of these vehicles should be sold to a wholesaler, such as when a vehicle has been in inventory for an extended period of time.

  Charting each vehicle this way supplies management with important information including whether any used cars that are purchased ultimately being wholesaled. If so, it chart will provide conclusive evidence that the buying practices of the used car managers are not matching demand.

- Determine who the five wholesalers from whom the dealership does the most purchasing and compare the list to a list of the five wholesalers to whom the dealership sells the most wholesale vehicles.

This table will help to indicate whether there are any wholesalers that may have "side deals" with used car managers at the detriment of the dealership. For example, cars may be sold to a particular wholesaler and repurchased at a later date at a higher price.

- Determine the mix of the used car inventory (trade-ins vs. purchased)

  Approximately 60% to 70% of the used car inventory should be the result of trade-ins. A vehicle that is traded in at the dealership generally costs the dealership less than a vehicle purchased on the outside since management can usually assign a more favorable value than what would normally be paid at an auction or to a wholesaler for the same type vehicle.

- Review reconditioning costs

  Generally, vehicles that are to be sold wholesale are not reconditioned (however, they may be detailed to look more presentable to the wholesaler or auction). A review of the vehicles that were sold wholesale may show that the dealership is unnecessarily reconditioning those units. Unless it can be proven that the cost of reconditioning those cars provided additional gross profit to the dealership, then these additional costs, if eliminated, would result in additional net income.

12.114 Inventory Control. As noted in section 3.208, the general rule of thumb is that a dealership should carry a 30-day supply of used cars. This practice covers the used car inventory taken as a whole. As with new cars, the dealership maintains its used car inventory records on a specific identification basis in the used car inventory schedule. The used car inventory schedule, which is the dealership's perpetual inventory record, lists every used vehicle in inventory, usually in stock number order. Also, the information usually includes the date that the vehicle was stocked in and the number of days elapsed from that date.

12.115 Using this schedule, management can ascertain the age of specific vehicles. A listing of all used cars in inventory for longer than 45 or 60 days, factoring in interest at the dealership's borrowing rate, supplies management with concrete evidence of the necessity of selling these specific vehicles. As the car ages, its value continues to decrease.

Parts Department

12.116 Purchases. The parts department purchasing function must be tightly controlled. Loose controls translate into lost dollars for the dealership. The following is a short summary of areas to address in order to increase profitability:

- Does the parts department have sole control of purchase orders?

  The parts department is the main purchasing agent for the dealership. As such, they should have exclusive responsibility of maintaining purchase orders. Allowing other departments to control purchase orders may cause inefficiencies which filter to the bottom line. The controller and/or the parts manager should be able to apprise the accountant as to which departmental personnel have access to purchase orders.

- Are the purchase orders written before or after the purchase?

The function of a purchase order is to be a record as to what was agreed with the vendor prior to a purchase. This record would show items to be purchased, quantities ordered and purchase price. Once the invoice is received, the purchase order is reviewed for agreement. Any discrepancies should be handled immediately. If the purchase order is written at the time that the invoice is received, all of the above controls are lost.

- What percentage of parts are purchased from outside vendors?

The vast majority of parts are purchased from the manufacturer. Parts purchased this way generally replenish stock. Parts purchased from outside vendors are typically for one of the following reasons:

a) A part is needed immediately.

These parts are usually purchased from other dealerships at the manufacturer's cost plus a certain percentage (10% to 25%). Of course, the parts department cannot stock every conceivable part. However, a substantial amount of parts purchased from other dealerships may indicate that the parts department does not carry an appropriate array of parts. As a result, the parts department is paying premium prices for parts that should have been purchased directly from the manufacturer in the first place.

b) The cost of the same part (from a parts warehouse or auto supply store) is less than from the manufacturer.

On the surface, this may appear to be true. The out-of-pocket cost for a part may be less than a part purchased from the manufacturer. A part purchased from the manufacturer, though, has other aspects that reduces the part's ultimate cost. The first is a stockorder allowance (or discount) which the manufacturer gives which decreases the total cost of a stockorder purchase. The other aspect is the manufacturer's parts return policy. For each part purchased from the manufacturer, a certain percentage of the cost is accumulated in a parts return "bank." This "bank" enables the dealership to return older, unsold parts to the manufacturer for a full refund. By factoring in these two additional aspects, the relative costs become more equalized.

c) A cheaper version of the part (such as floor mats) is available.

Customer satisfaction should not be the only concern should the cheaper version of the part prove inferior. Another concern should be whether the parts manager might be having a side deal with the supplier to buy these parts in quantity for personal gain (such as gifts or money).

d) The manufacturer does not sell the part.

This can be true with accessory items such as clothing, cellular phones, etc. Management should carefully evaluate the level of inventory to carry in these areas since return privileges may be non-existent.

12.117 Inventory Control. Sections 3.307 through 3.315 reflect the basic controls that a parts department should have over their inventory.

Service Department

12.118 Inventory Control. Work in process inventory and sublet repairs inventory are the two principal inventory areas under the authority of the service department. If controls are lax in either of these two areas, considerable dollars may be lost.

12.119 As noted in section 3.412, the mechanics time is "flagged" on each repair order. This flagging serves two purposes; it is used to determine the sale and cost of sale of the labor for each repair order and is the support for paying wages to the mechanic. When the mechanic is paid, the labor is recorded to work in process inventory; the inventory account is relieved when the repair order is recorded.

12.120 One service that the accountant can perform is a flag test. This test may reveal that one or more mechanics are being paid more than the amount that is costed on repair orders. One explanation may be that payroll is using a different hourly rate for the mechanic than the repair order costing clerk is using. Another, more dishonest reason, may be that the mechanic's time that is sent to payroll is actually different than the time recorded on repair orders. The flag test would catch these and other reasons for discrepancies.

12.121 In order to perform a flag test, randomly selected flag sheets that have been used to pay mechanics are compared to the related repair orders for agreement and vice versa. Generally, flag tests are performed when work in process inventory is on an upward trend with little or no increase in business.

12.122 Sublet repairs inventory originates when the dealership pays an outside company for providing sublet repair work (as discussed in paragraph 3.404). The inventory account is relieved when the repair order is recorded. The accounting department maintains a sublet repairs inventory subsidiary schedule that agrees to the general ledger, which separates each sublet repair payment and sale by repair order number. A review of this subsidiary schedule should reveal no sublet repair charges older than 30 days unless the repair order has yet to be closed. If there are old sublet repair charges, it may mean that certain sublet repairs are being paid by the dealership but not being properly reflected on repair orders.

12.200 BENCHMARKING

12.201 The monthly dealer financial statement shows by month and year to date the following information:

- total dollar sales and gross profit of new cars, the number of new cars sold and the average gross profit per car sold. This information is classified by model.
- total dollar sales and gross profit of used cars, the number of used cars sold and the average gross profit per car sold. This information is classified by retail and wholesale sales, and may be further separated by cars and trucks.
- total dollars sales, gross profit and gross profit percentage for each type of parts sale (retail counter, customer repair orders, warranty, internal, and wholesale sales).
- total dollars sales, gross profit and gross profit percentage for each type of service sale (customer repair orders, warranty, and internal sales).

12.202 Certain dealerships have the capability of presenting sales and gross profit information for the preceding eleven months for comparison purposes.

12.203 Useful dealership trend analyses should include the current month, the prior twelve months, and the average year to date for the current and immediate past years. These analyses, if not prepared by the dealership's personnel, can be compiled by the accountant.

12.204 These trends can be compared against results of other dealerships which are readily available to management and the accountant. Of course, no two dealerships are alike. However, the dealership's chief measurement results can be compared with those of other similar-sized dealerships to gain insight into the dealership's position within that group.

12.205 One source of comparative dealership financial results is from the manufacturer. The manufacturer should be supplying (or be able to supply) the dealer with certain sales information comparing the dealership with the other dealers in the same selling district. This information is useful in that it shows the dealer how well he is performing against his nearby competitors.

12.206 Another source is from the dealer's twenty group. The concept of a dealer twenty group started several years ago. A twenty group is generally comprised of, at the most, twenty dealers who sell the same type vehicle (i.e., the same franchise) and are approximately the same size but are not from the same market area. Since they are not in competition with one another, financial information from each dealership can be freely exchanged. This information is compiled in a monthly composite so that each dealer can compare their performance against the other dealerships and against the group average.

12.207 Not all dealers belong to a twenty group. However, there are hundreds of twenty groups nationally. The accountant should inquire of the dealer or general manager whether their dealership is a member of a twenty group.

12.208 Twenty groups are sponsored and monitored by a few organizations. The two largest organizations and their addresses are the following:

NADA 20 Group
8400 Westpark Drive
McLean, Virginia 22102
(703) 821-7000

NCM Associates
PO Box 12903
Shawnee Mission, Kansas 66212-2903
(800) 756-2620

12.209 A third source is from industry publications. One publication, *Auto Age Dealer Business* (See Section 2.802), has a section entitled *Database 2000* which is a composite of information supplied by a cross section of NCM Associates' 20 Group members who achieve 30 percent or more net-to-gross profit. The magazine provides monthly benchmarks in departmental operating components and productivity. Illustrations 12-1 and 12-2 as well as the benchmark definitions in Section 12.212 are reprinted with permission from *Auto Age Dealer Business*.

12.210 These benchmarks are not meant to be the absolute authority on how a dealership should operate. Rather, they should be used to highlight the relative strengths and weaknesses of the dealership.

12.211 For example, one weakness that may become evident through benchmarking a dealership could be that the average gross profit per vehicle salesperson is $2,000 less than these benchmarks even though the average retail gross profit per car sold retail meets or exceeds the benchmarks. This would indicate that the dealership possibly employs too many vehicle sales personnel.

12.212 Terms used in the benchmark illustrations 12-1 and 12-2 are defined as follows:

- **Vehicle retail gross** - Gross profit from sale of new and used vehicles (retail).
- **F&I gross** - Gross profit from sale of new and used F&I (less chargebacks).
- **Personnel expense** - Includes the following expense accounts: supervision; clerical; other salaries and wages; compensation specialist; employee bonus; absentee wages/idle time; payroll taxes; employee benefits; and pension fund.
- **Fixed coverage** - Total gross profit from Service, Body Shop, and Parts divided by the dealerships total expense of all departments after *selling expense*. Dealer salary and bonus is not included in total expense for purposes of this calculation.

Illustration No. 12-1 **Operating and Productivity Benchmarks**

	Chevrolet	Ford	Imports	Buick	Luxury Imports	Pontiac	Chrysler/ Dodge
Net profit return on sales							
New	2.5%	2.0%	1.4%	1.6%	2.1%	1.5%	2.2%
Used	4.0%	4.1%	3.5%	3.0%	1.1%	3.6%	4.1%
Parts	5.7%	5.8%	11.3%	5.2%	13.5%	5.6%	11.0%
Service	8.1%	14.6%	15.2%	8.1%	8.9%	10.6%	8.5%
Body Shop	10.4%	11.8%	9.4%	10.8%	3.4%	12.1%	12.8%
Total Dealership	4.1%	3.9%	3.2%	3.5%	3.6%	3.5%	4.6%
Net additions/deductions as a percent of total gross profit	3.7%	3.3%	4.7%	2.3%	1.5%	4.2%	6.1%
Total gross profit as a percent of sales							
New							
Used	8.6%	8.5%	8.9%	7.2%	9.5%	7.7%	7.6%
Parts	12.1%	12.8%	13.2%	11.5%	7.6%	11.4%	13.6%
Service	25.5%	30.1%	31.5%	26.2%	32.9%	25.6%	30.7%
Body Shop	50.8%	60.5%	63.5%	50.6%	67.3%	50.4%	61.0%
Total Dealership	41.0%	51.9%	51.4%	39.2%	47.7%	37.6%	53.5%
	12.9%	13.6%	13.7%	12.7%	14.8%	12.6%	13.7%
Total expense as a percent of total gross profit							
New	70.5%	76.9%	84.3%	77.2%	78.2%	80.2%	71.1%
Used	67.5%	67.9%	73.3%	73.7%	104.0%	68.7%	70.2%
Parts	77.7%	64.8%	64.1%	44.5%	59.0%	44.4%	64.3%
Service	84.0%	85.0%	76.1%	83.9%	86.8%	44.5%	86.2%
Body Shop	74.6%	90.4%	81.3%	72.3%	92.6%	34.5%	76.4%
Total Dealership	77.0%	76.4%	75.9%	77.1%	82.1%	33.8%	76.8%

SOURCES: *AUTO AGE DEALER BUSINESS*, JANUARY - JULY, 1995

12.212

Illustration No. 12-1 (Continued)

	Chevrolet	Ford	Imports	Buick	Luxury Imports	Pontiac	Chrysler/ Dodge
Total personnel expense as a percent of total gross profit	32.7%	32.6%	30.3%	35.5%	32.3%	33.8%	30.4%
Total gross profit per employee average month	$5,759	$6,158	$6,649	$5,247	$7,122	$5,056	$5,621
Gross per new vehicle retail (exludes F & I)							
Car	$1,424	$1,252	$1,381	$1,632	$3,480	$1,370	$1,387
Truck	$1,613	$1,549	$1,691	N/A	N/A	N/A	$1,623
Gross per used vehicle retail (excludes F & I)							
Car	$1,365	$1,315	$1,307	$1,409	$2,303	$1,415	$1,362
Truck	$1,527	$1,516	$1,315	N/A	N/A	N/A	$1,545
F & I warranty net							
New retail	—	$510	$382	—	$299	—	$409
Used retail	—	$442	$440	—	$456	—	$420
New & Used retail	$391	—	—	$266	—	$423	—
New & Used Advertising as a percent of retail gross	11.3%	10.0%	15.9%	12.3%	10.9%	14.0%	15.1%

N/A = NOT APPLICABLE

SOURCES: *AUTO AGE DEALER BUSINESS*, JANUARY - JULY, 1995

Illustration No. 12-1 (Continued)

	Chevrolet	Ford	Imports	Buick	Luxury Imports	Pontiac	Chrysler/ Dodge
New & Used variable/selling expense as a percent of retail gross	24.8%	49.1%	40.4%	22.8%	37.4%	25.4%	N/A
New & Used personnel expense as a percent of departmental gross	21.2%	15.1%	21.7%	23.5%	20.4%	22.3%	N/A
Floor plan/interest as a percent of new & used retail gross	0.6%	3.7%	7.9%	1.6%	9.9%	1.3%	0.4%
New & used departmental profit as a percent of departmental gross	31.3%	27.8%	19.8%	25.3%	17.7%	26.6%	27.8%
Service total labor gross as a percent of sales	71.6%	69.4%	74.6%	70.5%	74.8%	72.1%	69.8%
Body shop total labor gross as a percent of sales	65.2%	64.0%	60.6%	64.5%	58.1%	65.0%	62.3%
All parts & accessories gross as a percent of sales	28.2%	32.6%	32.9%	29.3%	34.6%	29.7%	32.9%
Service/body/parts departmental personnel expense as a percent of gross profit	44.6%	32.5%	38.2%	45.1%	37.8%	43.1%	N/A
Total service/body/parts departmental expense as a percent of departmental gross profit	79.0%	76.4%	67.8%	78.2%	70.3%	74.6%	75.1%
Fixed coverage/Service absorption	57.7%	86.7%	71.3%	67.6%	80.1%	63.6%	81.7%

N/A = NOT AVAILABLE

SOURCES: *AUTO AGE DEALER BUSINESS*, JANUARY - JULY, 1995

Illustration No. 12-2 **Expense Benchmarks as a Percent of Total Departmental Gross Profit**

	Percent Range
Compensation - vehicle salespeople	9.8 - 11.5
Delivery expense	0.4 - 0.6
Policy work / free service (new & used)	0.4 - 0.6
Supervisory salaries	8.7 - 10.3
Clerical / administrative salaries	1.8 - 2.8
Other salaries and wages	8.2 - 9.9
Absentee compensation	0.5 - 0.8
Payroll taxes	3.2 - 3.7
Employee benefits	1.9 - 2.6
Pension fund	0.2 - 0.7
Company vehicle and user maintenance	0.5 - 0.9
Office supplies	0.5 - 0.7
Other supplies	0.8 - 1.1
Advertising (all)	7.1 - 7.8
Contributions	0.1 - 0.2
Policy work (parts & service)	0.5 - 0.7
Outside services - data processing	0.5 - 0.8
Outside services - other	1.2 - 1.8
Travel and entertainment	0.3 - 0.4
Memberships, dues, publications	0.1 - 0.3
Legal and auditing	0.3 - 0.5
Telephone and freight	0.8 - 0.9
Training and promotion	0.5 - 1.0
Interest (all except mortgage interest)	1.7 - 4.0
Bad debts	
Miscellaneous	0.4 - 0.7
Rent	3.9 - 4.9
Amortization - leaseholds	0.1 - 0.2
Repairs - real estate	0.3 - 0.4
Depreciation - Building / Improvements	0.2 - 0.3
Taxes - real estate	0.4 - 0.6
Interest - mortgages	0.1 - 0.1
Heat, light, power, water	1.0 - 1.3
Insurance (all)	1.2 - 1.9
Taxes - other	0.3 - 0.6
Equipment repairs and rental	0.4 - 0.7
Depreciation - equipment	0.8 - 1.2

Source: ***Auto Age Dealer Business*** **(October, 1993)**

12.300 REGULATORY REVIEW

12.301 As noted in Section 2.600, an automobile dealership functions under numerous regulations. It is management's responsibility to design the necessary systems of control to comply with these regulations. Due to various reasons (e.g., employee turnover, being short-staffed, lack of training, etc.), compliance with many regulations may be lax. As a result, substantial fines may be levied against the dealership if non-compliance is discovered.

12.302 This section discusses certain laws and regulations that relate more to the dealership's operating aspects than to its financial and accounting aspects, with an indirect effect to the financial statements. Even though this section is written primarily for a separate consulting engagement, the guidance of SAS No. 54, *Illegal Acts By Clients* (AU Section 317), should be followed in conjunction with an audit of a dealership's financial statements. In addition, if as a consulting engagement, the procedures described in this section reveal facts that may have existed at the balance sheet date of the most recent audit which might have affected the auditor's report, then SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AU Section 561), should be followed.

12.303 There is a tremendous opportunity to the accountant to help management in this area. The following provides guidance in the various regulatory areas in which the accountant can review and report back to management.

Federal Regulations

12.304 Reporting Cash Receipts of Over $10,000. Section 6050I(a) of the Internal Revenue Code requires all recipients of more than $10,000 cash (as defined) to file an information return (Form 8300) with the Internal Revenue Service within 15 days after receipt of the cash. The definition of cash includes cashiers checks, bank drafts, travelers checks, and money orders that are less than $10,000, but when used in combination with each other or cash, amounts to a sum greater than $10,000. If a dealership does not comply with these reporting requirements, penalties of $25,000 to $100,000 may be assessed for each violation.

12.305 The first step that the accountant can do is to document the current procedures that the dealership employs to capture each transaction in which over $10,000 in cash is received. These procedures, at a minimum, should include documenting the customer's exact method of payment (e.g., $5,000 on a personal check, $2,000 on a credit card, $1,000 in cash and $1,500 in travelers checks). Documentation that does not allow the cashier to indicate the type of check received (personal, travelers, cashier, etc.) may allow reportable transactions to go unreported.

12.306 Once the documentation is completed, the procedures should be evaluated to determine whether the controls are adequate. For example, if the person responsible for capturing each applicable transaction misses one, is there another step in the procedures for this missed transaction to be captured?

12.307 One or more randomly selected months should be chosen for testing. Car deals that have been financed through the dealership should be reviewed to determine whether any customer had more than a $10,000 down payment (proceeds from contracts in transit are not considered "cash" under Section 6050I(a)). Deals that fit this parameter should be further reviewed to determine method of payment (copies of receipts should be in the deal jacket).

12.308 All other deals (i.e., deals not financed through the dealership) should be reviewed to determine method of payment. Should any car deals indicate that more than $10,000 in cash was received from the customer, the deal jacket should contain a copy of a properly completed Form 8300. If not, one should be filed immediately and controls reevaluated to determine where the breakdown occurred.

12.309 **Luxury tax.** This federal excise tax (Section 4001 of the Internal Revenue Code) is imposed on the first retail sale of a passenger vehicle which sells for more than $32,000. The tax is calculated as 10% of the sales price which exceeds $32,000.

12.310 In order to test compliance, one or more randomly selected months should be chosen for testing. The new vehicle sales journal should be scanned for those months and all car deals with a sales price of $31,500 or more should be selected for further review.

12.311 Special attention should be given to car deals which display a sale amount at or around $32,000 to determine whether the car deal was structured to avoid paying luxury tax. One way to improperly avoid luxury tax is by assigning an inappropriately low value to the customer's trade-in. The following example illustrates this impropriety:

	As reflected on sales invoice	Actual value
Trade-in value	$15,000	$20,000
Financed amount	19,020	19,020
	34,020	39,020
Sales tax (@ 6%)	(1,920)	(2,179)
Luxury tax	-	(431)
Tags/Title	(100)	(100)
Sale price	$32,000	$36,310

12.312 In the above example, not only is luxury tax understated but so is sales tax. Under the above scenario, management may adjust the used car up to its appropriate value at a later date.

12.313 The final step is to check whether the luxury tax that has been collected has been promptly reported and remitted to the Internal Revenue Service.

State Regulations

12.314 **Sales tax.** The regulations regarding sales tax varies based on applicable state and local taxing authorities. Regardless of the differing regulations, most sales taxing authorities require that sales tax be calculated properly and remitted promptly and that non-taxable sales be fully documented.

12.315 The specific rules regarding sales tax should be completely understood prior to testing for sales tax compliance. For example, is sales tax charged on the gross sale amount or gross sales less the trade-in? Is the sale of extended warranty subject to sales tax? Once the rules have been reviewed, the compliance test can begin.

12.316 In order to test compliance, one or more randomly selected months should be chosen for testing. Several deal jackets (for retail sales) should be selected from these months to verify that the proper amount of sales tax was calculated and recorded.

12.317 For exempt sales, the deal folders should be reviewed for proper documentation to support the exempt sales tax status.

12.318 The final step is to check whether the sales tax that has been collected has been promptly reported and remitted to the respective taxing authority.

12.400 CORRESPONDENCE WITH THE CLIENT

12.401 The following letter to management illustrates many of the elements discussed in this chapter:

Mr. Dealer
ABC Dealership
123 Main Street
City, State

Dear Mr. Dealer:

As you requested, we have spent the last week at ABC Dealership reviewing the operational and managerial practices of your personnel. This evaluation encompassed various areas including benchmarking ABC Dealership against comparably-sized dealerships throughout the United States as well as your market area. In addition, we assessed the dealership's compliance with current state and federal regulations. This letter is the result of our work.

<u>New/Used Car Department</u>

1. The dealership should only have a 45 day supply of new vehicles. The excess inventory is costing the dealership approximately $8,000 per month.
2. We found that the dealership's gross profits per new vehicles are lower than what we feel market conditions can bear. A target of increasing retail unit gross profits by $250 per car is attainable if managers' bonuses can be restructured (e.g., a bonus on reaching a minimum per new car gross profit).
3. We propose that all new and used car salespeople should be encouraged to sell used and new vehicles, respectively. In fact, we feel that each new car salesperson should sell at least 2 used vehicles and each used car salesperson 2 new vehicle before they become eligible to receive bonus compensation. This should help to increase your sales and lower the compensation expense.
4. Approximately one half of all used vehicles sold by the dealership are sold to wholesalers. This high percentage of wholesaled vehicles indicates that there may be vehicles that are being wholesaled that actually could have been retail units. The gross profit difference between a vehicle sold retail versus wholesale is over $1,200.

5. The dealership should be able to sell an additional $25-30,000 in extended warranty business by increasing the used car extended warranty penetration.
6. The used vehicle department is overstocked by approximately $225,000 based on current sales trends. This is costing the dealership about $900 per month in interest income if the amount of overstocked inventory had been invested.
7. A spreadsheet should be prepared on a monthly basis indicating the types of used cars sold for the month which should then be compared to the inventory on hand at the end of the month. This will help to pinpoint the vehicles which should remain in inventory against those vehicles which, perhaps, should be wholesaled. This analysis should not only be limited to types of vehicles but the age of the vehicles as well. Based on our review of the used car inventory, there are too many late model cars in inventory and not enough of the older cars.
8. In reviewing the finance and insurance area, we determined that the department's sole motivation is to generate F&I sales. Obviously, the generation of F&I sales is important but equally important is the generation of cash from those sales. Ideally, contracts should be paid within 3-7 days from delivery of the car. Currently, there are ten unpaid contracts more than two weeks old. In order to motivate the F&I manager to be more "cash conscious," we recommend a total revamping of the manager's pay plan so that both sales and cash collection objectives are met.

Parts Department

1. The stocking criteria should be reviewed occasionally by the general manager to ensure that the working capital invested in the parts department is effectively utilized. This may help cut down on unnecessary outside purchases. The goal of the parts department should be to purchase the inventory with less than 15% outside purchases.

Service Department

1. Management should track more frequently the type of service that is sold (e.g., oil changes, brake work, air conditioner repair, etc.). This tracking should include the age of the cars that are serviced and cars that are beyond the factory warranty period. By tracking the repair work that is performed, management can determine the types and frequency of repairs that are being sold. Also, based on this information, management should be able to determine whether the service advisors are just taking orders from customers or actually selling service and parts.

Regulatory Compliance

1. Additional procedures were implemented by the dealership concerning Form 8300. These new procedures should greatly improve the dealership's ability to identify reportable cash transactions on a more timely basis. We recommend that deposits on car deals be recorded on the face of the Buyer's Order by the cashier receipting the deposit. The cashier should record the date, receipt number, amount of deposit, method of payment and his/her initials. This procedure will facilitate the identification by the cashier of two or more cash deposits made on different occasions that exceeds the $10,000 reportable transaction requirement.

2. The dealership currently has a long list of vehicle export sales without bills of lading on file. An audit by the State Department of Revenue would mandate that sales tax be paid on these car sales due to improper documentation. We suggest that a new dealership policy be placed in effect whereby commissions to sales personnel on export deals that do not have a bill of lading be held until the bill of lading is received.

We appreciate the opportunity to be of service to you.

Sincerely,

CPA

Compilation and Review Engagements

CHAPTER 13

COMPILATION AND REVIEW ENGAGEMENTS

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CHAPTER 13

COMPILATION AND REVIEW ENGAGEMENTS

13.000 ACCEPTING THE ENGAGEMENT

Applicability

13.001 This chapter provides guidance for compilations and reviews of auto dealerships' financial statements. These engagements are governed by Statements on Standards for Accounting and Review Services (SSARS) Nos. 1 through 7. According to SSARS, the accountant must either compile or review unaudited financial statements of a nonpublic entity whenever he or she submits them. SSARS defines submission of financial statements as presenting them to a client, or other users when the accountant has done either of the following to the statements:

- Generated them, either manually or through the use of computer software, or
- Modified them by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements.

13.002 There are three general types of SSARS engagements that accountants provide for their auto dealership clients:

- Reviews of financial statements that include full disclosure
- Compilations of financial statements that include full disclosure
- Compilations of financial statements that omit substantially all disclosures

13.003 SSARS deal only with historical financial statements. An accountant is not bound by SSARS if the presentation is not a financial statement or is not historical. So, for example, SSARS do not apply to elements, items, or accounts, or to a trial balance because those presentations are not financial statements. Similarly, SSARS don't apply to forecasts or projections (including budgets) because they are not historical. Guidance on future-oriented information is provided by the AICPA Statement on Standards for Attestation Engagements No. 1, section 200, *Financial Forecasts and Projections* (AT 200), and the AICPA *Guide for Prospective Financial Information*.

SSARS Pronouncements

13.004 Table 13-1 lists the SSARS pronouncements. The full text of the SSARS pronouncements and related Interpretations are in the AICPA *Professional Standards*, Volume 2 (Product No. 005015), and in the AICPA *Codification of Statements on Standards for Accounting and Review Services* (Product No. 057166). Practice aids in the form of questions and answers on compilation and review matters written by the AICPA Technical Information Division staff, are included in the AICPA Technical Practice Aids (Product No. 005055).

TABLE 13-1

Statements on Standards For Accounting and Review Services (SSARS)

No. 1 *Compilation and Review of Financial Statements* (December, 1978)

No. 2 *Reporting on Comparative Financial Statements* (October, 1979)

No. 3 *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (December, 1981)

No. 4 *Communication Between Predecessor and Successor Accountants* (December, 1981)

No. 5 (Rescinded by SSARS No. 7)

No. 6 *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (September, 1986)

No. 7 *Omnibus Statement on Accounting and Review Services--1992* (November, 1992)

Practice Tip:

In addition to the seven SSARS listed above, over 20 interpretations of these pronouncements have been issued. They should be consulted when dealing with such issues as litigation services, draft financial statements, special purpose financial presentations, etc. These Interpretations are published in the AICPA *Professional Standards*, Vol. 2 and are reproduced in the AICPA's IPS Compilation and Review Manual, Appendix A.

Types of Services

13.005 Compilation. A compilation of financial statements is defined in paragraph 4 of SSARS No. 1, *Compilation and Review of Financial Statements*, (AR 100.04) as "presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements." SSARS No. 1 clearly states that performing a compilation does not require the accountant to make inquiries or perform other procedures to verify, corroborate, or review the client's information. Likewise, the accountant does not have to obtain an understanding of the client's internal control structure or assess control risk. This doesn't mean, however, that the accountant can compile financial statements that are known to be misleading. If the accountant becomes aware that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory, he or she should obtain additional or revised information. The accountant should withdraw from the engagement if the client refuses to provide additional or revised information.

13.006 As a result of the engagement, the accountant is required to issue a compilation report. The report states that a professional service was performed but provides no explicit assurance on the financial statements.

13.007 Review. In a review, the accountant expresses limited assurance on the financial statements of a nonpublic entity. Paragraph 4 of SSARS No. 1 (AR 100.04) defines a review as —

> Performing inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles or, if applicable, with an other comprehensive basis of accounting.

13.008 A review differs from a compilation in two principal ways. First, the accountant expresses limited assurance in a review, whereas no assurance is expressed in a compilation. Second, the accountant is required to perform specific types of procedures in a review — inquiries and analytical procedures — to obtains a reasonable basis for expressing that assurance. In a review, the accountant also obtains a signed client representation letter. In a compilation, no specific tests or documentation are required.

Client Acceptance

13.009 Client acceptance procedures for compilation and review engagements are similar to those for audit engagements. Section 4.100 describes such client acceptance and continuance issues. A Client Acceptance and Continuance Form that can be used for compilation and review engagements is provided in Chapter 4, section 4.501. Unlike, audit engagements, however, under SSARS No. 4 (AR 400) the accountant may choose to make inquiries of a predecessor accountant, but is not required to.

Establishing an Understanding With the Client

13.010 Once the accountant has decided to accept a engagement, he or she should establish an understanding with the client, preferably in writing, regarding: the services to be performed, the terms and objectives of the engagement, and the type of report anticipated. The understanding should also provide that the engagement cannot be relied on to disclose errors, irregularities, or illegal acts and that the accountant will inform the appropriate level of management of any material errors that come to his or her attention and any irregularities or illegal acts that come to his or her attention unless they are clearly inconsequential. Engagement letters are illustrated in Section 13.400.

13.011 The level of service performed and the nature of the report to be issued should be clearly stated. If there is an engagement letter, it should be revised for any significant changes from the original understanding with the client, that is, a step-up or step-down in the level of service.

13.012 The engagement partner should approve any change in the level of service. A step-up in level of service may occur after a revised understanding with the client. A step-down in level of service should occur only after carefully evaluating the reasons for change. The reasons for change also may affect the report on lower levels of service. Limitations in the scope of audits, for example, may preclude stepping-down to a review or compilation service. SSARS No. 1 (AR 100.44-.49) describes the accountant's considerations in deciding whether to change the engagement to a lower level of service.

13.100 COMPILATION ENGAGEMENTS

What Are the Requirements of a Compilation?

13.101 SSARS No. 1 requires the accountant to:

- Establish an understanding with the client, preferably in writing, regarding the services to be performed.
- Possess or obtain a level of knowledge of the accounting principles and practices of the industry in which the client operates.
- Possess or obtain a general understanding of the nature of the client's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, and the accounting basis and form and content of the financial statements.
- Consider whether it is necessary to perform other accounting services to be able to compile the financial statements.
- Read the compiled financial statements and consider whether they appear to be appropriate in form and free from obvious material misstatements.
- Request additional or revised information when the information provided by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.

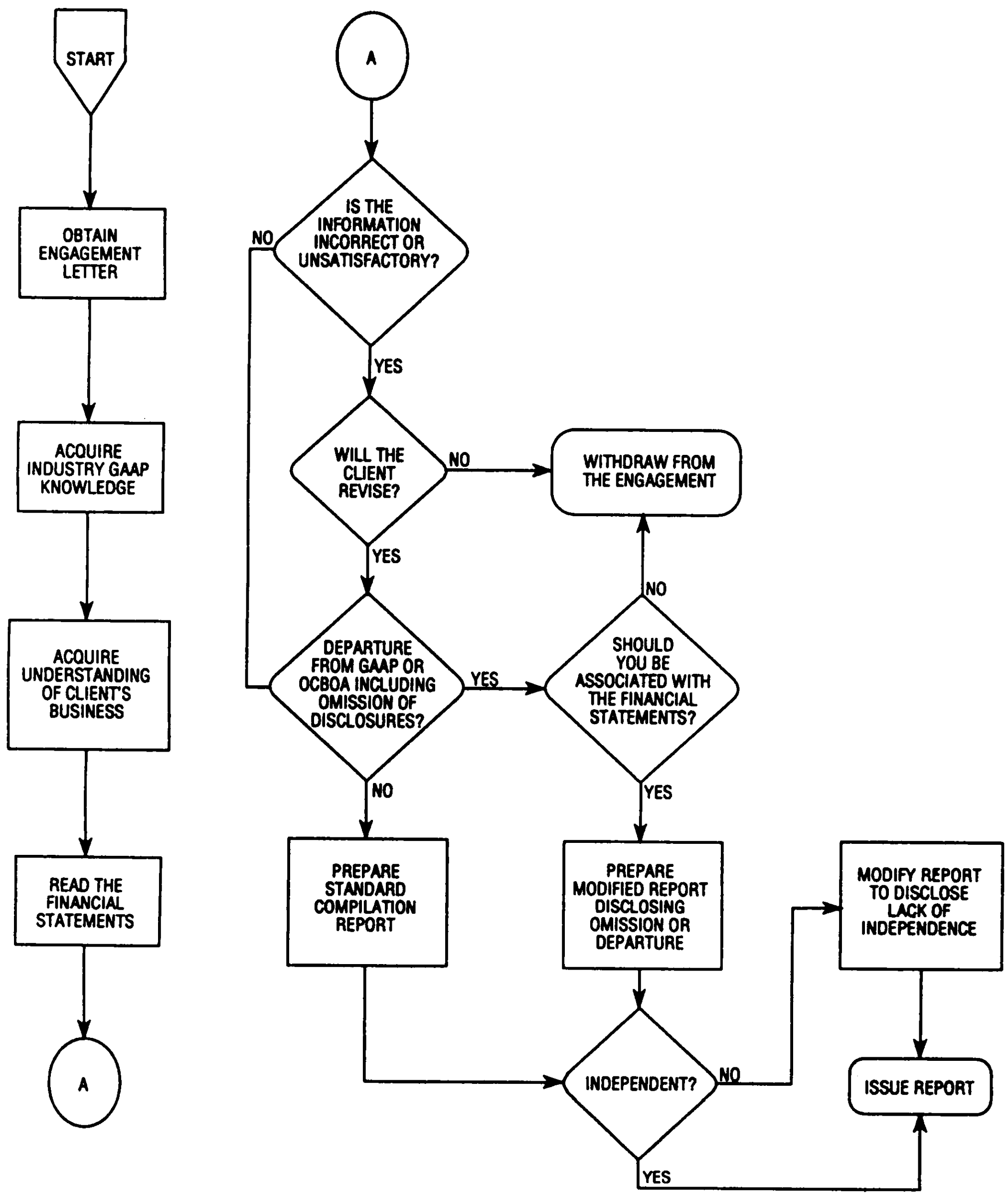
13.102 A flowchart for performing compilation services is set forth in Illustration 13-1. A compilation work program is provided in section 13.404.

13.103 Knowledge of the Client's Industry and Business. To compile an auto dealership's financial statements the accountant is required to have a knowledge of the accounting principles and practices of the industry and an understanding of the client's business. The accountant should know enough about the accounting principles and practices used in the industry to understand the proper form and content of the client's financial statements and to recognize a misstatement in them. In the authors' opinion, this does not mean that the accountant must be a specialist in auto dealerships. It simply requires that the accountant be familiar with the accounting principles and practices particular to that industry.

13.104 SSARS No. 1 does not require the accountant to possess industry knowledge before accepting the engagement. As long as the accountant obtains the required knowledge before the engagement is completed, the SSARS requirement is satisfied. The description of the auto-dealership industry in this Manual should be helpful in gaining an understanding of the industry, particularly when combined with industry publications and periodicals (see Chapter 2), reading financial statements of other dealerships (see Chapter 11), and, when deemed necessary, consultation with individuals knowledgeable about the industry.

Flowchart for Performing Compilation Services

ILLUSTRATION NO. 13-1



13.105 Knowledge of the Client's Business. SSARS require the compiling accountant to have a general understanding of the nature of the entity's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, the accounting basis on which the financial statements are to be presented, and the form and content of the financial statements (AR 100.11). Completing the Form for Documenting Understanding of the Auto Dealership's Business and Industry — Compilation and Review Engagements (section 13.402), along with the Client Acceptance and Continuance Form (section 4.501), will ordinarily provide an understanding of the client's business that meets the requirements of SSARS.

13.106 The accountant usually obtains an initial understanding of the client's business by making inquiries and observations and looking at relevant documents. After obtaining the initial understanding, the accountant need only update it in succeeding engagements.

13.107 Consider the Need to Perform Other Accounting Services. The accountant should not compile financial statements from accounting records that he or she believes are likely to be materially incorrect or incomplete because of the lack of appropriate records. Therefore, based on his or her knowledge of the client, the accountant may find it necessary to arrange to perform additional services to update or adjust the client's accounting records before compiling the financial statements.

13.108 Request Additional or Revised Information. Although the accountant is not required to perform any procedures to verify information supplied by the client, he or she may become aware that information provided is incorrect, incomplete, or otherwise unsatisfactory. In such circumstances, the accountant should obtain additional or revised information. If the client refuses to provide additional or revised information, the accountant should withdraw from the compilation engagement. This requirement does not apply to information that is not disclosed when management has elected to omit substantially all of the disclosures required by generally accepted accounting principles.

13.109 Read the Compiled Financial Statements. The required reading of the financial statements is designed to bring the accountant's knowledge of industry accounting principles and the client's business to bear on the financial statement presentation. In reading the financial statements, the accountant should be alert for arithmetic or clerical errors as well as mistakes in the application of accounting principles, including inadequate disclosure.

Compilation Reports

13.110 The accountant is required to issue a report when a compilation engagement is completed. Compilation reports are issued in three basic forms:

- The standard report (full-disclosure financial statements).
- The standard report modified for the omission of substantially all disclosures.
- The standard report modified for departures from GAAP.

13.111 The compilation report:

- States that a compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

- States that a compilation is limited to presenting management's representations in the form of financial statements.
- States that an audit or review has not been performed and no opinion or assurance is being expressed.
- Provides no explicit assurance on the financial statements.
- Discloses material departures from generally accepted accounting principles (GAAP).

13.112 The standard compilation report reads as follows:

> We have compiled the accompanying balance sheet of XYZ Motors as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended in conformity with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

13.113 Standard Compilation Report Modified for the Omission of Substantially All Disclosures. A compilation report can be issued on financial statements that omit substantially all disclosures provided the omission is not intended to mislead users. The report must clearly disclose this omission (AR 100.19-.21). The report should make it clear that management, not the accountant, made the decision to omit the disclosures required by GAAP. If the financial statements are prepared on an other comprehensive basis of accounting (OCBOA) and don't disclose the basis of accounting, the basis should be disclosed in the accountant's compilation report.

13.114 Compilation reports can also be issued for financial statements that contain only selected informative disclosures. Such disclosures should be labeled "Selected Information — Substantially All Disclosures Required By Generally Accepted Accounting Principles Are Not Included."

13.115 Standard Compilation Report Modified for Departures From GAAP. If an accountant compiling financial statements becomes aware of a material departure from GAAP or OCBOA that is not revised, the accountant should consider whether modification of the standard report is adequate to disclose the departure. In rare circumstances, withdrawal from the engagement may be necessary.

13.116 If report modification for the departure is appropriate, the nature of the departure and its effects on the financial statements, if determined, should be included in a separate paragraph. Although not required, whenever feasible the accountant should attempt to determine the effects of departures if management has not done so.

13.117 Dating the Report. Compilation reports should be dated when all significant procedures have been completed; that is, when the accountant has completed reading the financial statements for obvious misstatements. This generally follows the completion of all significant procedures, including any resulting from the partner's review.

13.118 The authors recommend that the date should be presented at the bottom of the page along with the city and state, if not included in firm letterhead, as follows:

City, State
February 14, 19Y

13.119 If significant subsequent events are discovered before the report is issued, but after the completion of the engagement, the report should be dual-dated for the subsequent event. Subsequent events affecting previously issued reports will also cause the report to be dual-dated. The following is an illustration of a dual date:

City, State
February 14, 19Y, except for Note X as to which the date is February 25, 19Y

13.120 Financial Statement References to Report and Notes. All pages of the financial statements should refer to the compilation report and to the notes, as follows:

See accountants' compilation report and notes to the financial statements.

13.121 Lack of Independence. A compilation report may be issued when the accountant's firm is not independent with respect to the client. In that case the report should include an additional paragraph that states:

We are not independent with respect to XYZ Company, Inc.

13.200 REVIEW ENGAGEMENTS

What Are the Requirements of a Review?

13.201 An accountant who reviews financial statements must meet specific performance and reporting requirements. In general, these requirements are:

- Establish an understanding, preferably in writing, with the entity regarding the services to be performed and the report the accountant expects to render.
- Possess or obtain knowledge of the accounting principles and practices of the entity's industry and an understanding of the entity's business that will provide the accountant, through the performance of inquiry and analytical procedures, with a reasonable basis for expressing limited assurance.
- Perform inquiry and analytical procedures sufficient to provide a reasonable basis for expressing limited assurance.
- Perform additional procedures when the accountant becomes aware that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory. These procedures should be sufficient to achieve limited assurance.
- Obtain a representation letter from the owner, manager, or chief executive officer, and, if appropriate, the chief financial officer.

- Consider whether to modify the review report if the accountant becomes aware of a departure from GAAP that is material to the financial statements and the financial statements are not revised.

13.202 A flowchart for performing review services is presented in Illustration 13-2.

13.203 Knowledge of the Industry and Business. To review an auto dealership's financial statements the accountant is required to have a knowledge of the accounting principles and practices of the industry and an understanding of the client's business.

13.204 The accountant should know enough about the accounting principles and practices used in the auto dealership industry to (1) understand the proper form and content of its financial statements and to recognize a misstatement in them and (2) design, perform, and evaluate the results of the inquiry and analytical procedures necessary to achieve limited assurance. In the authors' opinion, this does not mean that the accountant must be a specialist in auto dealerships. It simply requires that the accountant be familiar with the accounting principles and practices particular to that industry.

13.205 SSARS No. 1 does not require the accountant to possess industry knowledge before accepting the engagement. As long as the accountant obtains the required knowledge before the engagement is completed, the SSARS requirement is satisfied. The description of the auto-dealership industry in this Manual should be helpful in gaining an understanding of the industry particularly when combined with industry publications and periodicals (see chapter 2), reading financial statements of other dealerships (see Chapter 11), and, when deemed necessary, consultation with individuals knowledgeable about the industry.

13.206 Knowledge of the Client's Business. In a review, the accountant should have a general understanding of the client's business in the following specific areas (AR 100.26):

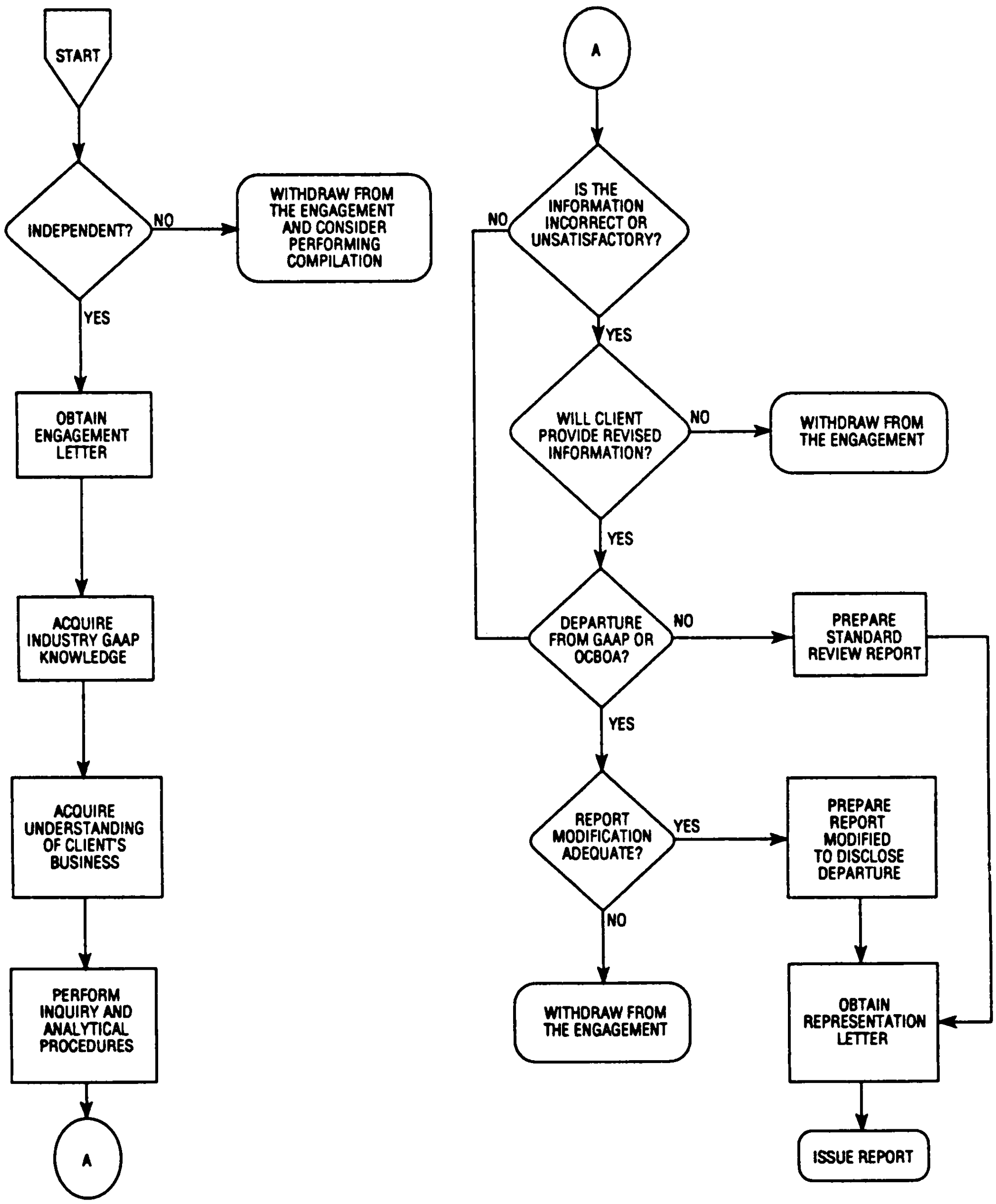
- The entity's organization
- The entity's operating characteristics
- The nature of the entity's assets, liabilities, revenues, and expenses

13.207 Knowledge of the business also normally includes a general understanding of the entity's production, distribution, and compensation methods; types of products and services; operating locations; and material transactions with related parties.

13.208 To determine how much knowledge of the entity's business is necessary to perform a review, emphasis should be placed on the term *general understanding* used in SSARS. The term general understanding means an overall familiarity or awareness, not an in-depth knowledge. Completing the Client Acceptance and Continuance Form (section 4.501), the Form for Documenting Understanding of the Auto Dealership's Business and Industry — Compilation and Review Engagements (section 13.402), and the Form For Documenting Understanding of the Auto Dealership's Business and Industry — Supplement for Review Engagements (section 13.403), will ordinarily provide an understanding of the client's business that meets the requirements of SSARS.

Flowchart for Performing Review Services

ILLUSTRATION NO. 13-2



13.209 The accountant usually obtains an initial understanding of the client's business by making inquiries and observations and looking at relevant documents. After obtaining the initial understanding, the accountant need only update it in succeeding engagements.

13.210 Inquiries. Inquiries involve asking questions of entity personnel about significant financial statement matters. For inquiries to be effective, they should be directed to entity personnel who are likely to be knowledgeable about the subject of the inquiry.

13.211 The accountant has considerable flexibility in determining the nature and extent of inquiries made in a review. Factors the accountant should consider when deciding which inquiries to make include (1) knowledge acquired in current and previous engagements, (2) the nature and materiality of financial statement items, (3) the likelihood of misstatement in a financial statement item, (4) the stated qualifications of accounting personnel, (5) the extent to which a particular item is affected by management's judgment, and (6) inadequacies in the entity's underlying financial data.

13.212 Paragraph 27 of SSARS No. 1 (AR 100.27) identifies the following major areas for the accountant's inquiries:

- The entity's accounting principles and practices and the methods of applying them
- The entity's procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements.
- Actions taken at meetings of stockholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements.
- Whether the financial statements have been prepared in conformity with GAAP, consistently applied.
- Whether there have been changes in the entity's business activities or accounting principles and practices.
- Matters about which questions have arisen in the course of applying review procedures, including analytical procedures.
- Events subsequent to the date of the financial statements that would have a material effect on the financial statements.

13.213 The Review Engagement Work Program in section 13.406 presents typical inquiries that may be made in a review of an auto dealership.

13.214 Analytical Procedures Analytical procedures are performed to help the accountant identify relationships and individual items that appear to be unusual. The consideration of unusual relationships or items helps the accountant obtain limited assurance about the financial statements. Paragraph 27 of SSARS No. 1 (AR 100.27) identifies three major categories of analytical procedures:

- Comparing the financial statements with those of comparable prior periods
- Comparing the financial statements with anticipated results

- Studying the relationships of financial statement elements that would be expected to conform to a predictable pattern based on the entity's experience

13.215 To compare the financial statements with those of prior periods, the accountant compares amounts in the current period financial statement accounts with those same accounts in comparable prior financial statements. For example, the accountant might compare current receivable, inventory, property, revenue, and expense amounts with the corresponding prior-period amounts to determine whether unusual or unexpected differences exist. Analyzing the trends in accounts over two or more periods by computing percentage changes is a common analytical procedure for this type of comparison.

13.216 Such comparisons should be made with *comparable* prior periods for the procedures to be effective. In addition, making these comparisons on a monthly basis or by operating unit or product line improves their effectiveness in detecting misstatements that occur in one or two months, in operating units, or in product lines.

Practice Tip:

If a client significantly changes the nature of its business, comparisons of certain data with that of prior periods might be irrelevant. In such circumstances, don't waste time making those comparisons. Additional inquiries and other analytical procedures should be performed to provide a basis for the limited assurance provided by the review report.

13.217 Comparison with anticipated results involves comparing significant amounts in current period financial statement accounts with budgets or forecasts for those accounts. Of course, budgets or forecasts must be available and the accountant should consider whether they represent realistic estimates before deciding to make these comparisons.

13.218 Some financial statement elements are correlated to others. For example, a change in a dealership's sales generally results in an accompanying change in cost of sales and finance and insurance income. Changes in property and equipment are generally accompanied by changes in depreciation expense and maintenance and repairs expense. These relationships are often analyzed by computing ratios or performing reasonableness tests. Ratios depict the relationship between two financial statement amounts. Reasonableness tests use logical relationships between financial or nonfinancial data to estimate what a financial statement amount or change in such an amount should be. Before studying such relationships, the accountant should consider the potential effect on those relationships of the types of adjustments required in prior periods.

13.219 The categories of analytical procedures summarized above are only suggested by SSARS No. 1. The accountant may perform others, such as making comparisons to industry data (Chapter 10 provides some summarized industry data that might be helpful). Furthermore, SSARS No. 1 does not set forth specific analytical procedures that accountants must perform. Accountants should choose the analytical procedures to be used in the circumstances by considering the following factors:

- The specific financial statement assertion to be addressed — existence; completeness; valuation; rights and obligations; or presentation and disclosure.

- Adjustments required in prior periods that suggest the likelihood of similar misstatement in the current period.
- The materiality of the account.
- Prior experience in choosing and applying analytical procedures for the client.
- The extent to which a particular item is affected by management's judgment.
- Availability and usefulness of industry statistics.

Practice Tip:

Don't apply analytical procedures mechanically. Comparing amounts over time, calculating trends and ratios, and performing reasonableness tests for the same account might be excessive. In addition, if the likelihood of material misstatement is low, the accountant may not need to apply any analytical procedures to that account.

13.220 Section 13.406 provides a program for analytical procedures; section 13.407 provides an illustrative analytical procedures checklist.

Practice Tip:

For some engagements, for example, those involving new dealerships, there is a limited amount of comparable data to perform analytical procedures. In these situations the accountant can study expected relationships within the current period. In addition, the accountant can make more inquiries and scan accounting ledgers and journals for unusual items to provide evidence. Also, don't ignore the evidence that is obtained from preparing any accounting schedules that may be necessary to compile the client's financial statements. Chapter 10 provides some industry data that may be helpful in applying analytical procedures in these cases.

13.221 Before performing analytical procedures, the accountant should determine the changes in amounts, percentages, or relationships that he or she would consider significant. In making this determination the accountant should consider the following factors:

- *The extent of changes occurring in prior periods.* Some change is likely to be expected based on changed conditions or circumstances.
- *Financial statement materiality.* Changes should be evaluated in light of materiality for the financial statements taken as a whole.

- *The nature of the relationship.* Some analytical procedures are based on direct, straightforward relationships involving few variables. Other analytical procedures use indirect relationships or involve a number of different variables. Changes identified by direct-relationship analytical procedures are usually more accurate. Therefore, the accountant would be more likely concerned about smaller changes from these types of analytical procedures than from the indirect-relationship procedures.

13.222 Representation Letters. SSARS No. 7, *Omnibus Statement on Accounting and Review Services—1992*, requires, among other things, that an accountant obtain a representation letter in a review engagement. A sample representation letter for a review engagement is presented below. SSARS does not require, or even mention, client representations in compilation engagements.

Illustrative Representation Letter

(Client's Letterhead)

(Date of Accountant's Report)

(To the Accountant)

In connection with your review of the (identification of financial statements) of (name of client) as of (date) and for the (period) then ended for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your review.

1. That the financial statements referred to above present the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles. In that connection, we specifically confirm that—

   a. The company's accounting principles, and the practices and methods followed in applying them, are as disclosed in the financial statements.

   b. There have been no changes during the (period) in the company's accounting principles and practices.

   c. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

   d. There are no material transactions that have not been properly reflected in the financial statements.

   e. There are no material losses (such as from obsolete inventory or purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.

   f. There are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

g. There are no estimates subject to material change in the near term or concentrations that make the entity vulnerable to risk of severe impact in the near term that are required to be disclosed in accordance with SOP 94-6.

h. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged

i. There are no related party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.

j. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

k. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

2. We have advised you of all actions taken at meetings of stockholders, board of directors, and committees of the board of directors that may affect the financial statements.

3. We have responded fully to all inquiries made to us by you during your review.

____
(Name of owner or chief executive officer and title)

____
(Name of chief financial officer and title, when applicable)

Review Reports

13.223 Review reports are issued in two basic forms:

- The standard report
- The standard report modified for departures from GAAP.

13.224 The standard review report:

- States that a review was performed in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA, and that all information is management's representation.

- States that a review consists primarily of applying inquiries and analytical procedures to financial data.
- States that the scope of a review is less than an audit and no opinion is being expressed.
- States that no material modifications are necessary for the statements to conform with GAAP.
- Discloses material departures from GAAP

13.225 The standard review report is illustrated below:

We have reviewed the accompanying balance sheet of XYZ Motors as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended in conformity with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Motors.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

13.226 Qualified and Adverse Reports. SSARS No. 1 does not permit qualified or adverse reports. A client's limitation on the procedures necessary to complete a review, or other conditions, will preclude issuing a review report. Reasons for such limitations should be carefully considered because ordinarily they also will preclude issuing a compilation report.

13.227 Departures from GAAP that are not revised should be disclosed in the report provided such disclosure is sufficient to prevent the financial statements from being misleading. If disclosure in the accountant's report is not sufficient, the in-charge should consult with the engagement partner to consider withdrawing from the engagement. The firm's service objective should be, of course, to persuade the client to make any appropriate revisions to the financial statements and related disclosures.

13.228 If report modification for the departure is appropriate, the nature of the departure, and its effects on the financial statements, if determined, should be included in a separate paragraph. Although not required, whenever feasible the accountant should attempt to determine the effects of departures if management has not done so.

13.229 Uncertainties. Financial statements presented in conformity with GAAP should disclose information about significant uncertainties affecting the client's financial statements, including those related to the client's ability to continue as a going concern. As long as the accountant believes that disclosures about uncertainties are adequate, there is no need to modify the review report. The accountant, however, may decide to add a paragraph to his or her report to emphasize those uncertainties.

13.230 The accountant may become aware of matters that may adversely affect the client's ability to continue as a going concern. Such conditions might include, for example, negative cash flows from operations, defaults on loan agreements, adverse financial ratios, work stoppages, and legal or regulatory proceedings.

13.231 The accountant's performance and reporting obligation is the same for a going-concern uncertainty as for other uncertainties — the adequacy of financial statement disclosures must be considered.[1] Provided the financial statements appropriately disclose the uncertainty, the accountant is not required to modify his or her report. The accountant may, however, elect to add a separate paragraph to his or her report that discusses a going-concern uncertainty.

12.232 Dating. Review reports should be dated when all significant procedures have been completed the engagement is generally complete when all significant procedures, including any resulting from the partner's review, have been completed.

12.233 The authors recommend that the date should be presented at the bottom of the page along with the city and state, if not included in firm letterhead, as follows:

> City, State
> February 14, 19Y

12.234 If significant subsequent events are discovered before the report is issued, but after the completion of the engagement, the report should be dual-dated for the subsequent event. Subsequent events affecting previously issued reports will also cause the report to be dual-dated. The following is an illustration of a dual date:

> City, State
> February 14, 19Y, except for Note X as to which the date is February 25, 19Y

13.235 Financial Statement References to Report and Notes. All pages of the financial statements should be referenced to the compilation or review report and to the notes, as follows:

> See accountants' review report and notes to the financial statements.

13.236 Lack of Independence. The accountant cannot issue a review report on financial statements when his or her firm is not independent. He or she may issue a compilation report, however (see section 13.121).

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[1] Footnote 18 of SSARS No. 1 (AR 100.40, fn. 18) states that in evaluating the adequacy of the disclosure of going-concern uncertainties, the accountant should look to the guidance provided in paragraphs 10 and 11 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341.10-.11).

13.300 SPECIAL SSARS ENGAGEMENTS

Financial Statements Prepared On an Other Comprehensive Basis of Accounting (OCBOA)

13.301 Applicability of SSARS. An accountant may be engaged to compile or review the financial statements of an entity that prepared its statements on a comprehensive basis of accounting other than GAAP. This possibility is specifically recognized in SSARS, as indicated by the following definition of a financial statement contained in SSARS No. 1:

> A presentation of financial data, including accompanying notes, derived form accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles.

Therefore, if an accountant submits an OCOBA financial statement to his or her client or others, the accountant should comply with the requirements of SSARS. The accountant must at a minimum compile the financial statements.

13.302 Income Tax Basis of Accounting. The income tax basis of accounting involves preparing financial statements based on the methods and principles that are used by the client to file its income tax return. Entities that typically use the income tax basis of accounting include small businesses for which conversion to GAAP is costly, and partnerships for which income tax basis financial statements provide the most useful information to the financial statement users.

13.303 Cash Basis of Accounting. The cash basis of accounting records transactions on the basis of cash receipts and disbursements. Using this method of accounting, revenues are recognized when the cash is received rather than when the revenues are earned, and expenses are recognized when they are paid rather than when the obligations are incurred. Entities typically use the cash basis of accounting when conversion to GAAP is costly.

Practice Tip:

An entity for which conversion to GAAP is too costly should probably use the income tax basis of accounting as opposed to the cash basis of accounting, if the entity files an income tax return.

13.304 The cash basis may be modified by including certain accruals that have substantial support. Ordinarily, a modification has substantial support if the method is equivalent to GAAP and its use is not illogical. For example, it would be illogical to record revenue on the accrual basis and expenses on the cash basis. Modifications that have substantial support include capitalizing fixed assets, recognizing debt arising from cash transactions, recording depreciation on fixed assets, and accruing income taxes on cash basis income. When accompanied by these modifications the basis of accounting is often described as the *modified cash basis*.

13.305 Titles of OCBOA Financial Statements. The titles used for OCBOA financial statements are important. They should be descriptive of the accounting basis used and avoid the implication that the financial statements are presented in conformity with GAAP. Examples of titles that are appropriate include *"Statement of Assets and Liabilities--Modified Cash Basis," "Statement of Revenues Collected and Expenses Paid," and "Statement of Revenues and Expenses--Income Tax Basis."*

13.306 Statement of Cash Flows. When a set of financial statements purport to present financial position and results of operations in conformity with GAAP, SFAS No. 95, *Statement of Cash Flows,* requires presentation of a statement of cash flows. According to AICPA Technical Practice Aid 1300.10, it is understood that the phrase "financial position and results of operations" refers to a GAAP presentation. Because OCBOA financial statements do not purport to present financial position and results of operations, presentation of a statement of cash flows for tax or cash basis financial statements is optional.

13.307 Disclosures. Disclosures in OCBOA financial statements are similar to those contained in GAAP financial statements. Footnote 4 of SSARS No. 1 states that SAS No. 62, *Special Reports* (AU 623), provides disclosure guidance for OCBOA financial statements. (See section 13.112 when reporting on compiled OCBOA financial statements that omit substantially all disclosures.)

Financial Statements Included in Prescribed Forms

13.308 Various bodies design or adopt standard preprinted forms that require specific financial information about another entity. Banks, credit agencies, industry trade associations, manufacturers, and governmental and regulatory agencies are common examples of bodies that use such forms. Because these forms are designed to meet the specific requirements of the bodies using them, they often call for departures from GAAP. Such departures might pertain to measurement principles not in conformity with GAAP, such as not requiring disclosure of commitments or contingencies.

13.309 Under the reporting requirements in SSARS No. 1, GAAP or OCBOA departures must be disclosed in the accountant's compilation report. However, SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed* Forms (AR 300), provides an alternative form of compilation report on financial statements included in prescribed forms. The essence of this provision is elimination of the requirement to describe GAAP departures in the accountant's compilation report *for those departures required by the prescribed form.* The rational underlying this provision is the presumption that the information required by a prescribed form is sufficient to meet the needs of the body that designed or adopted the form and that there is no need for the accountant to advise that body of GAAP departures required by the form.

13.310 The alternative report allowed by SSARS No. 3 is an option. The accountant may always elect to follow the reporting requirements in SSARS No. 1 and disclose all GAAP departures, including those called for by the prescribed form.

13.311 The reporting alternative for prescribed forms is available only for a compilation service. There is not provision for an alternative review report. If financial statements in a prescribed form are reviewed, all material GAAP departures, including those called for by the form, must be disclosed in the accountant's review report.

Report on Elements, Accounts, or Items of a Financial Statement

13.312 An accountant may be asked to report on a separate presentation of specified elements, accounts, or items of a financial statements. Examples of such information include a schedule of net sales, a schedule of inventories, a schedule of accounts receivables, and a schedule of general and administrative expenses.

13.313 SSARS No. 1 provides guidance for the compilation and review of complete financial statements; not for specified elements, accounts, or items of a financial statement. Therefore, the accountant is not required to report on specified elements, accounts, or items, even when the accountant prepares and submits such presentations to a client or a third party. That is, the presentation of specified elements, accounts, or item of a financial statement may be conveyed (1) without any report, (2) with a simple transmittal letter, or (3) with a report that is descriptive of the accountant's services.

13.314 If the accountant decides to issue a report on the compilation of specified elements, accounts, or items of a financial statement, the authors suggest that the accountant comply with the performance standards contained in SSARS, and model the report after the compilation report on financial statements contained in SSARS No. 1. However, the reference to standards established by the American Institute of Certified Public Accountants should be omitted, because there are no standards that apply to the compilation of such information.

13.315 The accountant who is engaged to review elements, accounts, or items of a financial statement should refer to the guidance in SSAE No. 1, *Attestation Standards* (AT 100).

Reporting on Supplementary Information

13.316 When supplementary information accompanies compiled or reviewed financial statements in an accountant-submitted document, the accountant must indicate the degree of responsibility he or she is taking for such information.

13.317 At the bottom of, and always on the same line of each page of, the basic financial statements and the supplementary information there should be a specific reference, as follows:

> See accountants' (review) report.

13.400 DOCUMENTATION

Illustrative forms and checklists for compilation and review engagements include:

- Engagement Letter—Compilation (section 13.401)
- Form for Documenting Understanding of the Auto Dealership's Business and Industry--Compilation and Review Engagements (section 13.402)
- Form for Documenting Understanding of the Auto Dealership's Business and Industry--Supplement for Review Engagements (section 13.403)
- Compilation Engagement Work Program (section 13.404)
- Engagement Letter -- Review (section 13.405)
- Review Engagement Work Program (section 13.406);
- Review Engagement Analytical Procedures Checklist (section 13.407)
- Review Engagement Checklist (section 13.408), and
- Representation Letter -- Review Engagements (section 13.222).

13.401 ENGAGEMENT LETTER—COMPILATION ENGAGEMENT

[Firm's Letterhead]

[Date]

____

____

____

This letter is to confirm my (our) understanding of the terms and objectives of my (our) engagement and the nature and limitations of the services I (we) will provide.

I (We) will perform the following services:

- I (We) will compile, from information you provide, the annual and interim balance sheets and related statements of income, retained earnings, and cash flows of ____________________ [client name] for the year 19__. I (We) will not audit or review such financial statements. My (Our) report on the annual financial statements of ____________________ [client name] is presently expected to read as follows:

    I (We) have compiled the accompanying balance sheet of ____________________ [client name] as of ____________ [financial statement date] and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

    A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

    My (Our) report on your interim financial statements, which will omit substantially all disclosures, will include an additional paragraph that will read as follows:

    Management has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

    If, for any reason, I am (we are) unable to complete the compilation of your financial statements, I (we) will not issue a report on such statements as a result of this engagement.

- I (We) will assist your bookkeeper in adjusting the books of account so that he or she will be able to prepare a working trial balance from which financial statements can be compiled. Your bookkeeper will provide me (us) with a detailed trial balance and any supporting schedules I (we) require.

- I (We) will also prepare the federal and ______________ [state] income tax returns for ________________________ [client name] for the fiscal year ended ______________.

My (Our) engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, I (we) will inform the appropriate level of management of material errors that come to my (our) attention and any irregularities or illegal acts that come to my (our) attention, unless they are clearly inconsequential.

My (Our) fees for these services....

I (We) shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to me (us).

Sincerely yours,

____

Acknowledged:

____

____
Title

____
Date

13.402

Form for Documenting Understanding of the Auto Dealership's Business and Industry—Compilation and Review Engagements

Client: ____________________

Financial Statement Date: ____________________

INSTRUCTIONS:

This form should be completed for all compilation and review engagements (other than for personal financial statements). When used in conjunction with the Client Acceptance and Continuance Form, the form provides documentation of the required understanding of the client's business and industry. It should be reviewed and updated annually for any changes in the client's business.

I. INDUSTRY INFORMATION

A. Describe major types of products or services provided by the client:

	% of Volume
New car sales	
Used car sales	
Service	
Other (specify)	

B. Describe any sources of information about the client's accounting principles (e.g., AICPA guides, industry publications):

II. ACCOUNTING PRINCIPLES

A. What is the basis of accounting to be used for the financial statements both on an annual and interim basis [GAAP or other comprehensive basis of accounting (describe)]?

1. Annual financial statements: ______________________
2. Interim financial statements: ______________________

B. Describe the client's significant accounting policies:

III. ACCOUNTING RECORDS

A. What is the form of the client's accounting records?

Record	Form of the Records Manual/Computer		Personnel Responsible
Journals:			
Cash receipts	M	C	________
Cash disbursements	M	C	________
Sales	M	C	________
Purchases/Voucher	M	C	________
Payroll	M	C	________
General	M	C	________
________	M	C	________
________	M	C	________
Ledgers:			
General	M	C	________
Accounts Receivable	M	C	________
Accounts payable	M	C	________
Perpetual Inventory	M	C	________
Physical Inventory Schedule	M	C	________
________	M	C	________
________	M	C	________

B. If the client uses accrual basis accounting, describe the client's procedures, if any, for achieving an adequate cutoff of transactions when the financial statements are prepared.

C. Describe the client's procedures for taking a physical count of its inventory. State how often it is taken.

IV. STATED QUALIFICATIONS OF ACCOUNTING PERSONNEL

Name	Responsibilities	Qualifications

V. OTHER INFORMATION

A. Is there economic dependency on a major customer? _________ If so, describe customer and percent of sales.

B. Describe the nature of any stock plans (e.g., stock options, repurchase, etc.).

C. Describe any transactions with related parties, including the nature of the relationship.

D. Describe any other information that is significant to the engagement.

	19____	19____	19____	19____	19____
Prepared/updated by:					
In-charge	______	______	______	______	______
Reviewed by:					
Partner	______	______	______	______	______

13.403

Form for Documenting Understanding of the Auto Dealership's Business and Industry—Supplement for Review Engagements

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be completed for all review engagements. When used in conjunction with the Client Acceptance and Continuance Form and the Form for Documenting Understanding of Client's Business and Industry — Compilation and Review Engagements, this form provides documentation of the additional required understanding of the client's business and industry required for review engagements. It should be reviewed and updated annually for any changes in the client's business.

I. ORGANIZATION AND PERSONNEL

A. Identify and describe the responsibilities of the chief officers.

Name	Responsibilities

B. Describe the locations at which the client does business and the nature of the activity and number of employees at each location.

C. Describe briefly the compensation methods for each class of employees.

II. OPERATING CHARACTERISTICS

A. Describe the company's sources of revenue, marketing, and distribution methods.

B. Describe the nature of the client's significant assets and liabilities.

C. Describe the nature of the client's significant expenses.

D. Describe the client's production process.

	19___	19___	19___	19___	19___
Prepared/updated by: In-charge	______	______	______	______	______
Reviewed by: Partner	______	______	______	______	______

13.404

Compilation Engagement Work Program— Auto Dealership

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

The following is a general guide for compiling annual and interim financial statements of auto dealerships. Any additional inquiries or procedures performed, and conclusions reached, should also be documented in the working papers. The "N/A" column should be checked for any steps that are not applicable or for steps not required because of immateriality or other reasons. References preceded by "AR" are to *Statements on Standards for Accounting and Review Services,* included in volume 2 of the AICPA *Professional Standards.*

	Performed By		
	Initials	Date	N/A
1. Prepare or update the Client Acceptance and Continuance Form.	______	______	☐
2. Consider whether the CPA firm is independent of the client. If the firm is not independent, the compilation report should be modified to indicate that fact. (AR 100.22)	______	______	☐
3. Establish or update an understanding with the client, preferably in writing, regarding the nature of the engagement. Include in the working papers a copy of the engagement letter or a memorandum describing the oral arrangements. (AR 100.08)	______	______	☐
4. If the firm was originally engaged to perform a higher level of service, i.e., a review or audit, document the appropriateness of the decision to step-down, including a consideration of:			
a. The reason given for the client's request, particularly the implications of a restriction on the scope of the initial engagement, whether imposed by the client or by circumstances.	______	______	☐
b. The additional effort required to complete the initial engagement.	______	______	☐

COMPILATION ENGAGEMENT WORK PROGRAM— AUTO DEALERSHIP (Continued)

	Performed By		
	Initials	Date	N/A
c. The estimated additional cost to complete the initial engagement. (AR 100.44-.49)	______	______	
5. Consider whether the staffing and scheduling of the engagement is appropriate.	______	______	☐
6. Complete or update the Form to Document Understanding of Auto Dealership's Business and Industry—Compilation and Review Engagements.	______	______	☐
7. Obtain assurances about the independence of any other accountants engaged to perform segments of the engagement.	______	______	☐
8. Perform any accounting services required to compile the financial statements. (AR 100.11)	______	______	☐
9. Consider whether any information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory. If so, request revised information. (AR 100.12)	______	______	☐
10. Draft the financial statements and the compilation report.	______	______	☐
11. If the financial statements do not omit substantially all disclosures, complete the Financial Statement Disclosure Checklist.	______	______	☐
12. If the financial statements are prepared on some other comprehensive basis of accounting, consider whether the financial statement titles and disclosure of the basis of accounting are appropriate. (AR 100.19-.21)	______	______	☐
13. Read the financial statements and consider whether they appear to be appropriate in form and free from obvious material misstatements. (AR 100.13)	______	______	☐
14. If the financial statements omit substantially all disclosures required by GAAP or some OCBOA, add an additional paragraph to the compilation report disclosing the omission. (AR 100.19-.21)	______	______	☐

COMPILATION ENGAGEMENT WORK PROGRAM— AUTO DEALERSHIP (Continued)

	Performed By Initials	Date	N/A
15. If GAAP basis financial statements of a business entity that omit substantially all disclosures also omit the statement of cash flows, modify the additional paragraph to disclose the omission. (AR 100.21 and footnote 8)	______	______	☐
16. If the financial statements contain a departure from GAAP or OCBOA, including either a measurement or disclosure departure:			
a. Revise the financial statements or modify the compilation report to indicate the departure.	______	______	☐
b. If the financial statements are not revised, consider whether modification of the standard report is adequate to indicate the deficiencies in the financial statements.	______	______	☐
c. If modification of the report is not considered adequate, consider withdrawing from the engagement. (AR 100.39–.41)	______	______	☐
17. If the financial statements are presented with comparative financial statements for one or more prior periods, determine that all financial statements are appropriately reported on by the CPA firm or a predecessor CPA firm. (AR 200.01–.36)	______	______	☐
18. If financial statements that are presented in a prescribed form are being reported on in accordance with SSARS 3, determine that the report complies with the requirements of that Statement. (AR 300.01–.05)	______	______	☐
19. If supplementary data accompanies the financial statements, modify the compilation report to include the other data. (AR 100.43)	______	______	☐
20. Include a reference to the compilation report on each page of the financial statements and supplementary data. (AR 100.16)	______	______	☐
21. Date the compilation report as of the date the compilation was completed. (AR 100.15)	______	______	☐
22. Document any other procedures performed or unusual problems and their resolution.	______	______	☐

COMPILATION ENGAGEMENT WORK PROGRAM— AUTO DEALERSHIP (Continued)

	Performed By		
	Initials	Date	N/A
23. Determine that all required forms and checklists have been completed.	______	______	☐
24. Determine that all review points by the engagement team and the technical reviewer (if applicable) have been resolved.	______	______	☐

Prepared by: ______________________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________________ Date: ______________________
(Engagement Partner)

13.405 ENGAGEMENT LETTER—REVIEW ENGAGEMENT

[Firm's Letterhead]

[Date]

____
____
____

This letter is to confirm my (our) understanding of the terms and objectives of my (our) engagement and the nature and limitations of the services I (we) will provide.

I (We) will review the balance sheet of ____________________________________ [client name] as of ____________________ [balance-sheet date], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) review will consist primarily of inquiries of company personnel and analytical procedures, and I (we) will require a client representation letter from you. A review does not contemplate obtaining an understanding of the internal control structure or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that I (we) will become aware of all significant matters that would be disclosed in an audit.

My (Our) engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, I (we) will inform the appropriate level of management of material errors that come to my (our) attention and any irregularities or illegal acts that come to my (our) attention, unless they are clearly inconsequential.

I (We) will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and accordingly, I (we) will not express such an opinion on them.

My (Our) report is presently expected to read as follows:

> I (We) have reviewed the accompanying balance-sheet of __________________ [client name] as of _________________ [balance sheet date], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of ____________________ [client name].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

If, for any reason, I am (we are) unable to complete my (our) review of your financial statements, I (we) will not issue a report on such statements as a result of this engagement.

I (We) will provide your bookkeeper with such consultation on accounting matters as he or she may be required in adjusting and closing the books of account and in drafting financial statements for my (our) review. Your bookkeeper also will provide me (us) with a detailed trial balance and any supporting schedules I (we) require.

My (Our) fees for these services....

I (We) shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to me (us).

Sincerely yours,

____

Acknowledged:

____

____

Title

____

Date

13.406

Review Engagement Work Program— Auto Dealership

Client: ______________________

Financial Statement Date: ______________________

PART I—INQUIRY PROCEDURES

INSTRUCTIONS:

The inquiry portion of this Work Program is a general guide for areas about which inquiries should be made in a review of a dealership's financial statements. The accountant may believe it is necessary to make several specific inquiries to answer one of the questions listed below. When additional inquiries are made, they should also be documented in the working papers.

Each of these inquiries will *not* necessarily apply to every review engagement. The "N/A" column should be checked for any inquiries that are not applicable. Inquiries may be inapplicable because of: (1) the nature or immateriality of financial statement accounts, (2) the low likelihood of misstatement in an account, (3) knowledge obtained during current or previous engagements, (4) the stated qualifications of entity's accounting personnel, or (5) the extent to which a particular item is affected by management judgment, among other reasons.

Area/Procedure	Performed By Initials	Performed By Date	N/A
GENERAL			
1. Obtain and agree or reconcile general and subsidiary ledgers.	______	______	☐
2. Obtain and foot general ledger trial balance.	______	______	☐
3. Obtain client-prepared financial statements or prepare financial statements and agree or reconcile them to the general ledger or the trial balance.	______	______	☐
CASH			

Inquire About:
- **Cash on hand and in banks**
- **Contracts in transit**

REVIEW ENGAGEMENT WORK PROGRAM—AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Date	N/A
1. Accounting principles and policies for cash and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing cash transactions.	______	______	☐
3. Whether bank and book balances have been reconciled.	______	______	☐
4. Disposition of old or unusual reconciling items.	______	______	☐
5. Whether a proper cash cutoff has been made.	______	______	☐
6. Restrictions on cash balances, such as compensating balances.	______	______	☐
7. Whether cash funds have been counted and reconciled with control accounts.	______	______	☐
RECEIVABLES — ACCOUNTS AND NOTES			
Inquire About:			
• **Factory receivables**			
• **Due from finance companies**			
• **Customer accounts**			
• **Other receivables**			
1. Accounting principles and policies for receivables and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing receivable transactions.	______	______	☐
3. Collectibility of receivables.	______	______	☐
4. Adequacy of allowance for doubtful accounts and whether uncollectible receivables were written off.	______	______	☐
5. Whether interest has been recorded, if applicable.	______	______	☐
6. Whether a proper sales cutoff has been made.	______	______	☐
7. Whether there are any receivables from employees and related parties.	______	______	☐

REVIEW ENGAGEMENT WORK PROGRAM— AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Performed By Date	N/A
8. Whether any receivables are pledged, discounted, or factored.	______	______	☐
9. Whether receivables are properly classified between current and noncurrent.	______	______	☐
INVENTORIES			
Inquire About: • **New vehicle inventory** • **Used vehicle inventory** • **Parts inventory**			
1. Accounting principles and policies for inventories and the methods of applying them, including the inventory valuation method and proper treatment of material, labor, and overhead, if applicable.	______	______	☐
2. Procedures for recording, classifying, and summarizing inventory transactions.	______	______	☐
3. Date and methods of performing most recent physical inventory.	______	______	☐
4. Whether general ledger control accounts have been adjusted to agree with physical inventories.	______	______	☐
5. Procedures for recording changes in inventory between physical inventory date and balance-sheet date, if applicable.	______	______	☐
6. Consideration of consignments-in and consignments-out.	______	______	☐
7. How obsolete or excess inventory has been valued.	______	______	☐
8. Whether a proper purchase cutoff has been made.	______	______	☐
9. Whether any inventory is encumbered.	______	______	☐

REVIEW ENGAGEMENT WORK PROGRAM—
AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Performed By Date	N/A
PREPAID EXPENSES AND OTHER ASSETS			
Inquire About:			
1. Accounting principles and policies for prepaid expenses and other assets and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing prepaid expense and other asset transactions.	______	______	☐
3. Nature of the items and amounts included in prepaid expenses and other assets, including whether items will benefit future periods.	______	______	☐
4. Methods for amortizing prepaid expense and other asset amounts.	______	______	☐
5. Whether prepaid expenses and other assets are properly classified between current and noncurrent.	______	______	☐
6. Whether other assets are mortgaged or otherwise encumbered.	______	______	☐
INVESTMENTS			
Inquire About:			
1. Accounting principles and policies for investments and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing investment transactions.	______	______	☐
3. Basis used to value investments, including marketable securities, joint ventures, intercompany investments, etc.	______	______	☐
4. Whether investment income has been recorded.	______	______	☐
5. Whether and how gains and losses on investment sales are recorded.	______	______	☐
6. Whether investments are properly classified between current and noncurrent.	______	______	☐

REVIEW ENGAGEMENT WORK PROGRAM— AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Date	N/A
7. Whether consolidation or equity requirements have been considered.	______	______	☐
8. Whether investments are encumbered.	______	______	☐
PROPERTY AND EQUIPMENT			
Inquire About:			
1. Accounting principles and policies for property and equipment and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing property and equipment transactions.	______	______	☐
3. Basis of valuation, depreciation methods, and criteria for capitalizing property and equipment.	______	______	☐
4. Whether and how gains and losses on property and equipment disposals are recorded.	______	______	☐
5. Whether depreciation and capitalization methods are used consistently.	______	______	☐
6. Unrecorded additions or disposals.	______	______	☐
7. Whether lease agreements exist and the nature of such leases (capital or operating).	______	______	☐
8. Whether property or equipment is mortgaged or otherwise encumbered.	______	______	☐
CURRENT LIABILITIES — ACCOUNTS, NOTES, AND ACCRUALS			
Inquire About:			
1. Accounting principles and policies for current liabilities and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing current liability transactions.	______	______	☐

REVIEW ENGAGEMENT WORK PROGRAM— AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Performed By Date	N/A
3. Whether all significant current liabilities have been recorded.	______	______	☐
4. Whether all current liabilities are properly classified.	______	______	☐
5. Whether there are any collateralized liabilities.	______	______	☐
6. Whether there are any current liabilities to employees or related parties.	______	______	☐
LONG-TERM LIABILITIES—NOTES, BONDS, AND MORTGAGES			
Inquire About:			
1. Accounting principles and policies for long-term liabilities and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing long-term liability transactions.	______	______	☐
3. Maturity dates, interest rates, restrictive covenants, and collateral for long-term liabilities.	______	______	☐
4. Whether long-term debt is properly classified as noncurrent.	______	______	☐
5. Whether and how interest expense and capitalized interest have been recorded.	______	______	☐
LIABILITIES FOR INCOME AND OTHER TAXES			
Inquire About:			
1. Accounting principles and policies for income and other taxes and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing income and other tax liability transactions.	______	______	☐
3. Whether provision has been made for state and federal income taxes and other taxes payable, such as sales, payroll, franchise, etc.	______	______	☐

REVIEW ENGAGEMENT WORK PROGRAM— AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Performed By Date	N/A
4. Recent or pending federal or state tax authority examinations.	______	______	☐
5. Whether deferred taxes have been recorded for significant temporary differences.	______	______	☐

OTHER LIABILITIES, COMMITMENTS, AND CONTINGENCIES

Inquire About:

Area/Procedure	Performed By Initials	Performed By Date	N/A
1. Accounting principles and policies for other liabilities and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, summarizing other liability transactions.	______	______	☐
3. Nature and amounts of other liabilities.	______	______	☐
4. Whether other liabilities have been properly classified between current and noncurrent.	______	______	☐
5. Whether obligations under any profit-sharing or bonus plans have been accrued.	______	______	☐
6. Whether there are any contingent liabilities, such as discounted notes, drafts, endorsements, warranties, litigation, and unsettled asserted claims.	______	______	☐
7. Whether there are any unasserted claims.	______	______	☐
8. Whether there are any commitments to purchase or sell company equity or debt securities.	______	______	☐
9. Whether there are any commitments to purchase, sell, or construct real property.	______	______	☐

REVIEW ENGAGEMENT WORK PROGRAM—AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Performed By Date	N/A
EQUITY			
Inquire About:			
1. Accounting principles and policies for equity and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing equity transactions.	______	______	☐
3. The nature of any changes in equity accounts.	______	______	☐
4. What classes of capital stock are authorized, number of shares issued and outstanding for each class, and their par or stated value.	______	______	☐
5. Whether amounts of outstanding shares of capital stock agree with subsidiary records.	______	______	☐
6. Whether capital stock preferences, if any, have been disclosed.	______	______	☐
7. hether stock options have been granted and the nature and terms of such options.	______	______	☐
8. Whether there are any treasury stock transactions.	______	______	☐
9. Whether there are any restrictions or appropriations of retained earnings.	______	______	☐
REVENUES AND EXPENSES			
Inquire About:			
1. Accounting principles and policies for revenues and expenses and the methods of applying them.	______	______	☐
2. Procedures for recording, classifying, and summarizing revenue and expense transactions.	______	______	☐
3. Whether sales, purchase, and expense cutoffs are proper.	______	______	☐

REVIEW ENGAGEMENT WORK PROGRAM— AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Performed By Date	N/A
4. Whether there are discontinued operations or other items that might be considered extraordinary.	______	______	☐
OTHER			
Inquire About:			
1. Whether any events have occurred after the balance sheet date that have a significant effect on the financial statements.	______	______	☐
2. Whether any actions taken at stockholder, board of directors, or comparable meetings that affect the financial statements have been properly recorded or disclosed.	______	______	☐
3. Whether material transactions with related parties have occurred and whether they are properly disclosed.	______	______	☐

PART II — ANALYTICAL PROCEDURES

INSTRUCTIONS:

The analytical procedures portion of this Work Program is a general guide for analytical procedures that may be performed in a review of financial statements of an auto dealerhip. The accountant may feel that additional analytical procedures are necessary in some areas. When additional analytical procedures are performed, they should also be documented in the working papers.

Each of these analytical procedures will not necessarily apply to every review engagement. The "N/A" column should be checked for any inquiries that are not applicable. Inquiries may be inapplicable because of the (1) nature or immateriality of financial statement accounts, (2) low likelihood of misstatement in an account, (3) knowledge obtained during current or previous engagements, (4) stated qualifications of entity's accounting personnel, or (5) extent to which a particular item is affected by management judgment, among other reasons.

Area/Procedure	Performed By Initials	Performed By Date	N/A
GENERAL			
1. Compare amounts in each significant account in the current financial statements with amounts for comparable prior period(s).	______	______	☐
2. Compare amounts in each significant account in the current financial statements with budgeted or forecasted amounts for the current period.	______	______	☐
3. Scan selected journals and ledgers.	______	______	☐
4. Based on the results of steps 1, 2 and 3 above, identify unusual fluctuations or relationships and document management's explanation for them.	______	______	☐

Specific Accounts:

For each significant account below, select and compute the analytical procedure(s) appropriate for this review engagement and compare the results with prior periods. The analytical procedures not considered necessary should be marked "N/A" and any additional analytical procedures performed should be documented.

REVIEW ENGAGEMENT WORK PROGRAM— AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Performed By Date	N/A
CASH			
1. Current ratio (current assets / current liabilities)	______	______	☐
2. Quick ratio (current assets — inventory / current liabilities)	______	______	☐
RECEIVABLES — ACCOUNTS AND NOTES			
1. Number of days' sales in ending accounts receivable (average net receivables × 360 / net credit sales)	______	______	☐
2. Bad debts expense as a percent of net sales (bad debts expense / net credit sales)	______	______	☐
3. Allowance for doubtful accounts as a percent of accounts receivable (allowance / ending receivables)	______	______	☐
4. Aged accounts receivable (percent of ending receivables in following categories):			
0 - 30 days	______	______	☐
31 - 60 days	______	______	☐
61 - 90 days	______	______	☐
91 - 120 days	______	______	☐
Over 120 days	______	______	☐
INVENTORIES			
1. Gross margin as a percent of net sales (gross margin / net sales)	______	______	☐
2. Inventory turnover (cost of sales / average inventory)	______	______	☐
INVESTMENTS			
1. Rate of return on major investment classes (investment income / average investment)	______	______	☐

REVIEW ENGAGEMENT WORK PROGRAM—AUTO DEALERSHIP (Continued)

Area/Procedure	Performed By Initials	Performed By Date	N/A
PROPERTY AND EQUIPMENT			
1. Depreciation expense as a percent of major property and equipment classes (depreciation expense / property and equipment)	______	______	☐
2. Accumulated depreciation as a percent of major property and equipment classes (accumulated depreciation / property and equipment)	______	______	☐
3. Repair and maintenance expense as a percent of property and equipment (repair and maintenance expense/property and equipment)	______	______	☐
LONG-TERM LIABILITIES—NOTES, BONDS, AND MORTGAGES			
1. Interest expense as a percent of major classes of average long-term liabilities (interest expense / average long-term liabilities)	______	______	☐
2. Long-term debt to equity (long-term liabilities / total equity)	______	______	☐
OTHER			
______________________________			
______________________________			
______________________________	______	______	☐

Prepared by: ______________________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________________ Date: ______________________
(Engagement Partner)

13.407

Review Engagement Analytical Procedures Checklist— Auto Dealerships

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

The following ratios should be calculated and the results reviewed for appropriateness. If a ratio is not applicable to the client the "N/A" column should be marked with a "✓". This checklist should be carried forward and updated yearly.

		Year or Period Ended		
	N/A	19	19	19
Notes and Accounts Receivable:				
1. Number of days net sales in accounts receivable.	____	____	____	____
2. Aged trial balance categories as a percent of total accounts receivable.	____	____	____	____
Number of days outstanding:				
0–30	____	____	____	____
31–60	____	____	____	____
61–90	____	____	____	____
91–120	____	____	____	____
121 +	____	____	____	____
3. Allowance for doubtful accounts as a percent of accounts receivable.	____	____	____	____
4. Bad debts expense as a percent of net sales.	____	____	____	____
Inventories:				
1. Gross profit as a percent of net sales:				
In total	____	____	____	____
By major product (if applicable)	____	____	____	____

REVIEW ENGAGEMENT ANALYTICAL PROCEDURES CHECKLIST—AUTO DEALERSHIPS (Continued)

	Year or Period Ended			
	N/A	19	19	19
2. Inventory turnover:				
In total	____	____	____	____
New vehicles	____	____	____	____
Used vehicles	____	____	____	____
Parts	____	____	____	____
3. Inventory composition as a percent of total inventory:				
a. New vehicles	____	____	____	____
b. Used vehicles	____	____	____	____
c. Parts	____	____	____	____
4. Composition of costs of sales as a percent of total costs of sales:				
a. Labor	____	____	____	____
b. Materials	____	____	____	____
c. Overhead	____	____	____	____
Working Capital:				
1. Current ratio.	____	____	____	____
2. Quick-current ratio.	____	____	____	____
Property and Equipment:				
1. Depreciation as a percent of:				
a. Net sales.	____	____	____	____
b. Total depreciable property and equipment.	____	____	____	____
Notes Payable and Long-Term Debt:				
1. Long-term debt to equity.	____	____	____	____
2. Interest expense as a percent of:				
a. Net sales.	____	____	____	____
b. Total debt other than open accounts.	____	____	____	____

REVIEW ENGAGEMENT ANALYTICAL PROCEDURES CHECKLIST— AUTO DEALERSHIPS (Continued)

	Year or Period Ended			
	N/A	19	19	19
Profitability:				
1. After tax rate of return on:				
a. Total assets invested.	____	____	____	____
b. Noncurrent assets.	____	____	____	____
c. Stockholders' equity at beginning of period.	____	____	____	____
d. Long-term debt and equity at beginning of period.	____	____	____	____
e. Total liabilities and equity at beginning of period.	____	____	____	____
Sales:				
1. As a percentage of net sales:				
a. Sales returns, allowances and discounts.	____	____	____	____
b. Earnings before income taxes.	____	____	____	____
c. Income taxes.	____	____	____	____
d. Net earnings.	____	____	____	____
e. Total selling expenses.	____	____	____	____
Comparisons of Balance Sheet and Income Statement Accounts in Excess of the Following Variances:				
1. Plus or minus $_______ from preceding year.	____	____	____	____
2. Plus or minus _______% from preceding year.	____	____	____	____
3. Plus or minus _______% from past three years' trend.	____	____	____	____

Accounts and Description of Variance:

____
____
____
____
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____
____
____

13.408

Review Engagement Checklist — Auto Dealerships

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This checklist is a general guide for reviewing annual and interim financial statements of auto dealerships. Any additional inquiries, analytical procedures, or other procedures performed, and conclusions reached, should also be documented in the working papers. The "N/A" column should be checked for any steps that are not applicable or for steps not required because of immateriality or other reasons. References preceded by "AR" refer to Statements on Standards for Accounting and Review Services included in volume 2 of AICPA *Professional Standards*.

	Performed By		
	Initials	Date	N/A
1. Prepare or update the Client Acceptance and Continuance Form.	______	______	☐
2. Consider whether the CPA firm is independent of the client. If the firm is not independent, a review report cannot be issued. (AR 100.38)	______	______	☐
3. Establish or update an understanding with the client, preferably in writing, regarding the nature of the engagement. Include in the working papers a copy of the engagement letter or a memorandum describing the oral arrangements. (AR 100.08)	______	______	☐
4. Consider whether the staffing and scheduling of the engagement is appropriate.	______	______	☐
5. Complete or update the Form for Documenting Understanding of the Auto Dealership's Business and Industry — Compilation and Review Engagements.	______	______	☐
6. Complete or update the Form for Documenting Understanding of the Auto Dealership's Business and Industry — Supplement for Review Engagements.	______	______	☐

REVIEW ENGAGEMENT CHECKLIST—AUTO DEALERSHIPS (Continued)

	Performed By Initials	Performed By Date	N/A
7. If the firm was originally engaged to perform a higher level of service, i.e., an audit, document the appropriateness of the decision to change to a review, including a consideration of:			
a. The reason given for the client's request, particularly the implications of a restriction on the scope of the audit, whether imposed by the client or by circumstances.	______	______	☐
b. The additional effort required to complete the audit.	______	______	☐
c. The estimated additional cost to complete the audit. (AR 100.44-.49)	______	______	☐
8. Obtain assurances about the independence of any other accountants engaged to perform segments of the engagement.	______	______	☐
9. Consider whether it is necessary to perform any accounting services or to compile financial statements to be able to perform the review. (AR 100.04)	______	______	☐
10. Complete the Review Engagement Work Program.	______	______	☐
11. Draft the financial statements and review report.	______	______	☐
12. Complete the Financial Statement Disclosure Checklist.	______	______	☐
13. If the financial statements are prepared using another comprehensive basis of accounting (OCBOA), consider whether the financial statement titles and disclosure of the basis of accounting are appropriate.	______	______	☐
14. Read the financial statements and consider, on the basis of information coming to the accountant's attention, whether the statements appear to conform with GAAP or OCBOA. (AR 100.27)	______	______	☐
15. If the financial statements contain a departure from GAAP or OCBOA, including either a measurement or disclosure departure:			
a. Revise the financial statements or modify the review report to indicate the departure.	______	______	☐

REVIEW ENGAGEMENT CHECKLIST— AUTO DEALERSHIPS (Continued)

	Performed By: Initials	Performed By: Date	N/A
b. If the financial statements are not revised, consider whether modification of the standard report is adequate to indicate the deficiencies in the financial statements.	______	______	☐
c. If modification of the report is not considered adequate, consider withdrawing from the engagement. (AR 100.39-.40)	______	______	☐
16. If the financial statements are presented with comparative financial statements for one or more prior periods, determine that all financial statements are appropriately reported on by the CPA firm or a predecessor CPA firm. (AR 200.01-.36).	______	______	☐
17. If supplementary data accompanies the financial statements, modify the review report to include the other data. (AR 100.43)	______	______	☐
18. Include a reference to the review report on each page of the financial statements and supplementary data. (AR 100.34)	______	______	☐
19. Date the review report as of the date the inquiry and analytical procedures were completed. (AR 100.33)	______	______	☐
20. Obtain a representation letter.	______	______	☐
21. Document any other procedures performed or unusual problems and their resolution.	______	______	☐
22. Determine that all required forms and checklists have been completed.	______	______	☐
23. Determine that all review points by the engagement team and the technical reviewer, if applicable, have been resolved.	______	______	☐

REVIEW ENGAGEMENT CHECKLIST— AUTO DEALERSHIPS (Continued)

	Performed By		
	Initials	Date	N/A
24. Other procedures: ____________________ ____________________ ____________________ ____________________ ____________________	____	____	☐

Prepared by: ______________________ (In-Charge) Date: ______________________

Reviewed by: ______________________ (Engagement Partner) Date: ______________________

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References are to section numbers.

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INTEGRATED PRACTICE SYSTEM

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